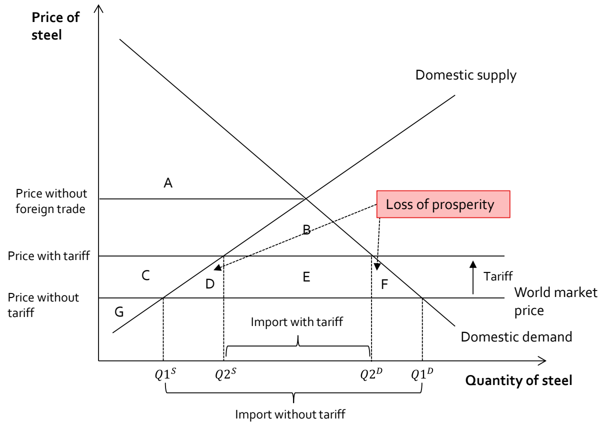
Economics for dummies: What will tariffs bring?

Donald Trump is stirring things up again. He announced last week that he intends to levy tariffs on steel and aluminum imports to the United States of 25% and 10%, respectively. The reaction to that has been significant. The stock markets have dipped, and other governments have immediately announced retaliatory measures. Is this reaction justified? To judge, we need to know what the goals and economic effects of imposing tariffs are. The announcement should not have surprised anyone, since Trump had advocated protectionist trade policy during the election campaign. The rallying cry "Make America great again!" made removing the causes of what he considered too low US economic growth his primary goal. Besides lower taxes, deregulation of markets, and lower energy costs, reducing trade deficits is one of the factors that are supposed to contribute to more growth and more jobs in the United States in the future. Finally, so the argument goes, a country's economic growth decreases (other things being equal), the more that it imports and the less that it exports. So, considered by itself, reducing the trade deficit should have a stimulating effect on growth. Higher import duties and lower imports should thus lead automatically to more growth. Right?

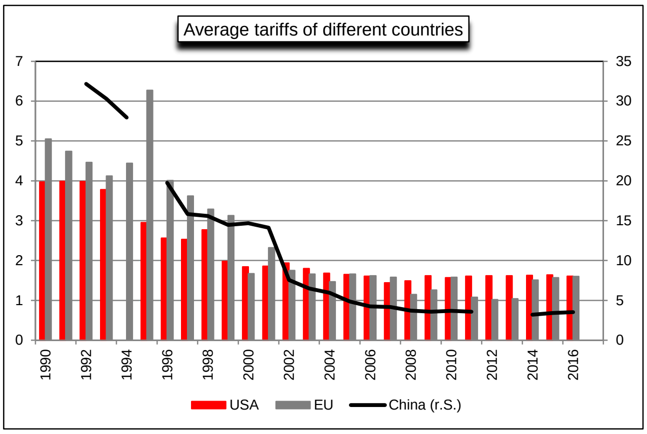
As always, Trump acts fully convinced that his strategy is correct. It does not matter to him that he antagonizes friends and trade partners by claiming that protecting the US steel industry is urgently necessary for reasons of national security. The United States would meet retaliatory measures by other countries (the EU, for example, has mentioned possible tariffs on US jeans, whiskey, and motorcycles) with further retaliation (e.g., tariffs on German cars). Trump thinks a possible trade war, which could significantly impede global economic growth, would be easy to win. If the United States has a deficit of USD 20 billion with a country, then he would say it can reduce the deficit by those USD 20 billion by completely cutting off trade with that partner. In 2017, the United States had a trade deficit of almost USD 800 billion, which is equivalent to 4% of total US GDP. The US current account deficit is somewhat smaller at about USD 450 billion, or about 2% of GDP. So, according to Donald Trump's simple calculation, a permanent reduction of the current account deficit by half would lead to economic growth that is about one percentage point higher. More growth, more jobs. Mission accomplished?

However, the world is not as simple as Donald Trump thinks (or wants us to think). If it were, tariffs and other non-tariff trade barriers would be a guarantor of prosperity and growth all over the world. But exactly the opposite is the case. Free trade and globalization lead to a greater supply of goods, lower production costs due to higher returns to scale, more competition, and technological progress and hence to lower prices. As a result, foreign trade increases the purchasing power of domestic consumers. In national accounts, imports have the effect of diminishing growth, but ultimately reflect consumption and capital investment, which in turn promote growth. On the other hand, tariffs work like a tax that makes products more expensive. Tariffs on steel and aluminum may therefore be easy to sell as pork barrel politics in an election campaign (is it a coincidence that an election for a seat in the US House of Representatives is coming up on March 13 in Pennsylvania, a state where the steel industry plays an important role?), since the affected companies benefit from a redistribution of prosperity to producers, while prosperity for consumers decreases due to higher prices. However, foreign trade theory shows that this is not a pure zero-sum game, but rather that tariffs lead to a net loss of prosperity. In the chart below, the areas A+B+C+D+E+F mark the consumer surplus without tariffs, and the area G represents the producer surplus. If tariffs are imposed, the consumer surplus is reduced by the areas C+D+E+F, the producer surplus increases to C+G, and national revenue increases by the area E. The sum of D+F represents the loss of prosperity. The trade restrictions will therefore counteract the growth-promoting effects of Trump's tax reform. Not more, but rather less growth and prosperity are the result.



But if the economic analysis regarding the impact of trade restrictions is so clear, why is protectionism so popular now? The most obvious reason is that although most of us have benefited from free trade, the "felt" extent of this advantage is rather small, especially since the positive aspects of free trade are by now regarded as given. On the other hand, free trade has some losers and their financial loss is very quantifiable and may well be heavy. If one saves USD 20 on the purchase of athletic shoes, that has less significance for the individual than in the case when one loses a well-paying steel plant job. But from a macroeconomic perspective, the income and consumption loss of those who lose their jobs normally weighs less than the additional consumption (and associated higher growth) of those who benefit from lower prices on product markets.

For these reasons, average tariffs imposed have decreased significantly in almost all countries, including the United States, in the past years. The average tariff in the United States stood at just under 4% at the beginning of the 1990s, but amounted to 1.6% in 2016. In the EU, the average was down from 5% to likewise 1.6% in the same period. On the other hand, higher tariffs may be found mainly in emerging countries, e.g., in Brazil, (8.0%), India (6.3%), China (3.5%), and Russia (3.4%). South Korea stands out among the developed countries with an average tariff of 7.7%, while import restrictions are low or even non-existent in countries like Japan (1.4%), Canada (0.9%), and Switzerland (0.0%).



However, we believe the punitive tariffs on steel and aluminum now put in play by the United States do not yet represent a fundamental shift away from free trade policy. That is because, for one thing, a tariff on steel is used not only in the United States but also in other countries and regions as a means of protecting domestic industries from the global oversupply of steel. Just before the presidential election in November 2016, 100 antidumping measures were already in force in the United States, and the Trump Administration has set in motion another 30 or more trade restrictions in this sector since then, but with less public impact than in the present instance. Punitive tariffs have been levied primarily against enterprises in China and South Korea, but also India and Japan have been affected to a greater than average extent. But the EU is also no choirboy in this respect and imposes considerable punitive tariffs on steel imports to combat dumping and subsidies. This concerns China and Russia, in particular.

There are good examples of the growth-diminishing effect of punitive tariffs. In March 2002, US President George W. Bush decided to impose tariffs on steel to protect the US steel industry from cheap Asian imports. A study concerning the effects of this measure concluded that prices for a large number of goods for which steel is an upstream product increased significantly because of it. Enterprises that purchase the more expensive steel as an intermediary product have two possibilities. They can either bear the higher costs themselves, in which case their profit margin decreases and they run the risk of going bankrupt. This is the alternative mainly for small businesses that have little or no pricing power. Or the steel-working companies can pass on the higher upstream product prices to their customers, thus shifting the problem of higher costs to those firms or to end-consumers. According to the study, import tariffs in 2002 led to a reduction of jobs in the United States by about 200,000, which was more than the number of people then working in the entire US steel industry. If Trump does levy new import tariffs, it is estimated that it might create 10,000 to 15,000 new jobs in the steel and aluminum industries. At the same time, though about 50,000 to 60,000 jobs are likely to disappear in other sectors. If other countries were to retaliate, the number of jobs lost in the US industrial sector could even reach 100,000 to 150,000.

What advice can one give now to European politicians about how to react to possible trade-inhibiting measures by the United States? Even though it is difficult, they should not allow Trump to provoke them and should try to maintain their composure. It is understandable that one wants to draw a line somewhere, but experience shows that a country that imposes tariffs thereby hurts itself more than any other. The Great Depression of the 1930s, presumably triggered in part by the protectionist Smoot-Hawley Tariff Act, amply demonstrates that there are only losers in a runaway trade war. In a study published in 2016, the Ifo Institute investigated in various scenarios how imposing import tariffs could impact the trade flows and economic output of the United States and other affected countries.[1] If the trade restrictions were limited, e.g., to China and Mexico, US imports would fall slightly, but exports would decrease somewhat more. Overall, there would be a slightly negative growth effect. On the other hand, if the United States were to extend the tariffs to all countries with which it trades, that would lead to considerable growth losses. Of course, such a development would have a negative effect on the entire world economy. But as long as all other countries continue to trade among themselves, the United States would be by far the biggest loser. What would Trump presumably say to that? "A VERY BAD deal!"

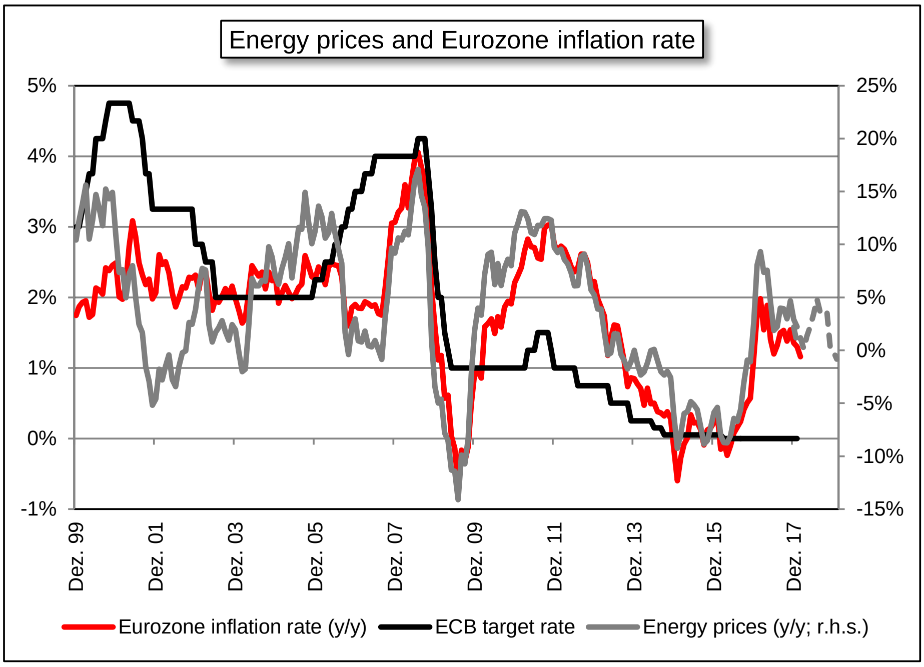
[1] http://www.cesifo.de/DocDL/sd-2016-22-felbermayr-steininger-trump-protektionismus-2016-11-24.pdf

Weekly outlook for March 12-16, 2018

	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Release
DE: Consumer prices, m/m – final	0.0%	0.3%	0.6%	-0.7%	0.5%		March 14
DE: Consumer prices, y/y- final	1.6%	1.8%	1.7%	1.6%	1.4%		March 14
EUR19: Industrial production, m/m	0.4%	1.3%	0.4%	0.3%			March 14
EUR19: Industrial production, y/y	4.0%	3.6%	5.2%	5.2%			March 14
EUR19: Consumer prices, y/y - final	1.4%	1.5%	1.4%	1.3%	1.2%		March 16
EUR19: Core inflation rate, y/y - final	0.9%	0.9%	0.9%	1.0%	1.2%		March 16

MMWB estimates in red

Chart of the Week: Easing bias cancelled



Once again, investors are focusing on the ECB Governing Council's meeting. There has not been speculation ahead of the meeting on a key interest rate hike, which is not likely until mid-2019 as the final step in normalizing monetary policy. Instead, there has been discussion about possible new information regarding a termination of the bond purchase program (currently EUR 30 billion per month). The minutes of the last several ECB meetings had contained a passage that said the size of the bond purchase program could be increased if the economic outlook or the sustainable inflation trend should worsen ("easing bias"). The question this time was whether that wording would be removed from the minutes given the very good economic momentum in the euro zone. And in fact, the easing bias is not there. So now, the first baby step has been taken away from ultra-accommodative monetary policy. At the same time, however, the statement remains that the bond purchase program can be extended beyond September 2018 until sustainable inflation is in sight – a sign that the ECB is not likely to normalize monetary policy all that fast. Accordingly, we should not read too much into this first, small step. ECB President Mario Draghi emphasized at the press conference that the central bank's monetary policy orientation has hardly changed. Only its confidence that a quantitative expansion will not be necessary has increased. Current inflation data and forecasts also show that a quicker change of monetary policy should not be expected. The ECB's inflation forecast is unchanged for 2018 at 1.4% and has even been revised slightly downward for 2019 from 1.5% to 1.4%%. Inflation rates may well approach 2% in the summer months, but that should not make investors nervous. So, overall, not much has changed today.

Stock marktes	As of 09.03.2018 14:18	Change versus 01.03.2018 -1 week	07.02.2018 -1 month	07.12.2017 -3 months	29.12.2017 YTD
Dow Jones	24895	1,2%	0,0%	2,8%	0,7%
S&P 500	2739	2,3%	2,1%	3,9%	2,4%
Nasdaq	7397	3,0%	4,9%	8,6%	7,1%
DAX	12296	0,9%	-2,3%	-5,7%	-4,8%
MDAX	26030	0,9%	0,6%	-0,4%	-0,7%
TecDAX	2679	4,6%	4,7%	7,7%	5,9%
EuroStoxx 50	3411	0,3%	-1,3%	-4,5%	-2,7%
Stoxx 50	3008	0,1%	-2,0%	-4,7%	-5,4%
SMI (Swiss Market Index)	8901	1,2%	-0,8%	-4,0%	-5,1%
Nikkei 225	21469	-1,2%	-0,8%	-4,6%	-5,7%
Brasilien BOVESPA	85074	-0,4%	2,8%	17,4%	11,3%
Russland RTS	1268	-0,5%	2,0%	13,3%	9,8%
Indien BSE 30	33307	-2,2%	-2,3%	1,1%	-2,2%
China Shanghai Composite	3308	1,0%	0,0%	1,1%	0,0%
MSCI Welt (in €)	2125	0,7%	1,6%	-1,2%	-1,4%
MSCI Emerging Markets (in €)	1195	-0,7%	2,3%	4,2%	0,7%
Bond markets					
Bund-Future	163,14	344	491	-53	146
Bobl-Future	130,27	-86	-23	-177	-134
Schatz-Future	111,83	-17	-2	-50	-15
3 Monats Euribor	-0,33	0	0	0	0
3M Euribor Future, Dec 2017	-0,28	-2	-2	0	0
3 Monats $ Libor	2,06	3	26	52	36
Fed Funds Future, Dec 2017	2,10	3	9	29	0
10 year US Treasuries	2,88	7	3	50	46
10 year Bunds	0,65	1	-4	35	22
10 year JGB	0,05	1	-2	1	0
10 year Swiss Government	0,10	10	1	27	23
US Treas 10Y Performance	559,69	-0,7%	-0,3%	-3,8%	-3,7%
Bund 10Y Performance	597,44	-0,2%	0,7%	-2,8%	-1,6%
REX Performance Index	477,65	0,0%	0,3%	-1,5%	-0,6%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,77	4	-1	24	9
IBOXX BBB, €	1,38	4	6	29	15
ML US High Yield	6,50	2	16	31	35
JPM EMBI+, Index	812	-0,1%	-1,4%	-2,5%	-2,9%
Convertible Bonds, Exane 25	7310	0,5%	-0,3%	-0,9%	-1,2%
Commodities					
CRB Spot Index	444,58	0,2%	0,6%	3,5%	2,8%
MG Base Metal Index	349,49	-0,5%	-2,8%	5,9%	-2,6%
Crude oil Brent	64,24	0,7%	-2,7%	3,6%	-3,6%
Gold	1316,75	0,9%	-0,4%	5,0%	1,0%
Silver	16,46	0,9%	0,5%	4,5%	-3,2%
Aluminium	2075,50	-3,6%	-4,0%	4,2%	-8,0%
Copper	6909,75	0,3%	1,1%	5,8%	-4,1%
Iron ore	73,01	-6,9%	-2,9%	8,3%	2,4%
Freight rates Baltic Dry Index	1197	0,1%	9,1%	-28,7%	-12,4%
Currencies					
EUR/ USD	1,2288	1,0%	-0,4%	4,3%	2,5%
EUR/ GBP	0,8888	0,1%	0,4%	1,1%	0,1%
EUR/ JPY	131,27	1,0%	-2,6%	-1,2%	-2,8%
EUR/ CHF	1,1691	1,5%	0,7%	-0,1%	-0,1%
USD/ CNY	6,3320	-0,4%	1,0%	-4,4%	-2,7%
USD/ JPY	106,08	-0,2%	-3,0%	-6,2%	-5,9%
USD/ GBP	0,72	-0,7%	0,4%	-2,9%	-2,1%

Carsten Klude	+49 40 3282-2572	cklude@mmwarburg.com	Martin Hasse	+49 40 3282-2411	mhasse@mmwarburg.com
Dr. Christian Jasperneite	+49 40 3282-2439	cjasperneite@mmwarburg.com	Dr. Rebekka Haller	+49 40 3282-2452	rhaller@mmwarburg.com
Bente Lorenzen	+49 40 3282-2409	blorenzen@mmwarburg.com	Julius Böttger	+49 40 3282-2229	jboettger@mmwarburg.com