Tit for Tat Trade Tiff

In the broad sweep of human history, nothing has contributed more to the advancement of the material condition of humanity than trade. If this seems like hyperbole, consider the immiserating impact of its opposite, autarky, a state in which each economic entity must be self-reliant, producing by its own devices all of the necessities of life. The progress in trade liberalization since WWII, which saw the steady decline of tariffs and non-tariff barriers, is now being dismantled by its erstwhile chief architect with uncertain short and long run ramifications for growth, inflation, and financial market stability.

Tariffs in the Broader Policy Context

The tariffs being imposed across an expanding set of imports and countries should be seen in the context of other U.S. economic policies, as there are conflicting crosscurrents.

Fiscal policy is procyclical, adding substantial stimulus to an economy operating above capacity in the wake of an ongoing recovery that is already the second longest in U.S. history. Monetary policy, in contrast, is tightening and likely to become increasingly contractionary in the face of very low unemployment and incipient wage and price pressure. The stimulus from the recently enacted tax cut will likely speed the pace of monetary tightening.

The expansionary fiscal stance will widen the current account deficit, notwithstanding higher tariffs, by increasing the demand for imports. The combination of expansionary fiscal policy and tightening monetary policy is likely, as it has in the past, to lead to an appreciation of the dollar. Any such appreciation would also tend to widen the current account deficit by reducing the competitiveness of U.S. exports, while encouraging imports.

Impact of Protectionism

Calibrating the impact of higher tariffs is complicated and any projection is subject to a great deal of uncertainty. The policy crosscurrents outlined above complicate the analysis as they are likely to offset at least part of the impact of tariffs. The ultimate scope and level of tariffs imposed by the U.S. is uncertain as new measures are announced with almost daily regularity. The extent of the retaliatory measures taken by trading partners is also unknown. The impact of the specter of a trade war on confidence represents the biggest wild card, as a marked deterioration in sentiment would dwarf the direct impact of tariffs alone. Moreover, existing models have a limited ability to capture the impact on individual sectors as global supply chains are disrupted. Finally, short-term data are likely being distorted by avoidance measures that have led to stockpiling in anticipation of the imposition of tariffs. All of these reasons suggest that forecasts of the impact of tariffs should be taken with a grain of salt.

A recent analysis by the IMF considers already adopted tariffs on aluminum (10%), steel (25%), and on $50 billion worth of imports from China (25%), announced tariffs of a further 10% on $200 billion of Chinese imports, car tariffs (25%), comparable retaliatory measures by the affected parties, as well as a confidence shock. Since this analysis was undertaken, the U.S. has said that it might impose tariffs on all Chinese imports, totaling $500 billion. The IMF analysis suggests a short-term loss of global GDP growth of 0.5% from a baseline projection of 3.9%. The U.S. economy, which as the focal point of retaliatory measures is the hardest hit, would lose 0.8% from the baseline projection of 2.7% GDP growth. All countries lose under this scenario, but the impact outside of the U.S. is partially mitigated by the redirection of trade away from the U.S. as corporations take steps to avoid tariffs.

While its short-run impact is significant, the IMF scenario is not expected to trigger an economic downturn. The impact on particular sectors could be quite significant, however. For example, steel prices have increased by 40% since the beginning of the year. The average price of washers and dryers sold in the U.S. rose by 20% in the three months through June. In financial markets, the shares of European and Asian automakers have underperformed the broad market, as have the shares of U.S. companies with a high level of sales to China. The disruption of global supply chains in a highly integrated world economy has potentially widespread, but essentially unknowable consequences.

There are already anecdotes of the unintended consequences of the tariffs arising due to the complexity of global supply chains and multinational firms. Whirlpool, for example, was an early beneficiary of tariffs on washers and dryers. However, the hoped-for benefits of these tariffs have been overwhelmed by subsequent tariffs on steel, a key intermediate good in the production of washers and dryers, resulting in pressure on Whirlpool's margins. Alcoa, an intended beneficiary of the aluminum tariffs, has seen its profit margin squeezed as aluminum produced by Alcoa in Canada is subjected to the new tariff.

We view the risk that the current trade tiff could escalate into a trade war as a key potential source of market instability, one that we are closely monitoring. We are particularly concerned that the uncertainty created could trigger a sudden change in sentiment and sharp market declines. Moreover, confidence effects could hurt consumer spending and corporate investment, slowing the pace of growth and innovation. While the extent of the short-term damage is unknowable, it is certain that a turn to protectionism would do significant cumulative harm to living standards over the long run.

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