TRADE

The Most Beautiful Word in the Dictionary

Ben Inker and John Pease | Asset Allocation

The global trade situation is at the top of almost everyone's mind at the moment. We have been working on a write-up of our research on the topic, but given how fluid the situation is, it's hard to state anything definitive on investment implications without being almost immediately rendered less relevant as the facts on the ground change. So for now, we are releasing the first part of the piece we have been working on, looking at the economics of trade and tariffs at a somewhat more theoretical level and explaining why broadly applied tariffs are likely to be a needlessly economically expensive way to achieve the goals the Trump administration is presumably trying to achieve. In the coming weeks we will release a companion piece talking more concretely about the likely impacts on currencies, equities, and credit from the kinds of tariffs that the administration is currently applying and/or contemplating.

Introduction

When you get home today, look around. You're standing in a house that you did not yourself build.[1] As you sneak into the kitchen to grab a slice of bread, note that you neither harvested its wheat nor kneaded its dough. In fact, you might not even know how to make bread. Your children – if you have them – probably spent the day occupied by other adults with no inherent obligation to take care of them, at a daycare center or school whose scheduling and programming you had no role in setting up.

The reason you have access to these things without ever having contemplated *making* them is a simple one: **trade.** Society values your work enough that it has allowed you to exchange what you produce – or if you've taken out debt, what you promise to produce – for goods and services created by others. This exchange is indeed what modern society is about. When we speak of the economy growing, what we really mean is that more trade (of newly produced goods and services) is occurring. When we discuss inflation, we are discussing how intertemporal trade – the exchange of present things for promises of future things – is becoming less attractive as values in the future are higher than those of the present.

There is no theoretical difference between national and international trade; in either case, goods and services (or promises thereof) are being exchanged. But practically, international trade has always been harder. In the not-so-good old days, this was because transportation costs were extremely high. Before the steam engine, crossing a large piece of land or a large body of water was both a costly and risky endeavor. The reason merchants such as Marco Polo and Columbus ended up rich was that their line of work demanded a risk premium, and they were fortunate enough to survive the risk and end up with the premium.

The extraordinary decline in transportation costs and tariffs[2] since the eighteenth century has made both national and international trade much easier. It has in consequence made the world much, *much* richer. Lower trade frictions translate to an expanding supply of essentially any tradable good or service, and an expanding supply curve means more production at lower prices (by way of greater competition). In other words, lower trade frictions help increase the world's standard of living.

1
In the off chance that someone reading this letter actually did build their own house, we can still posit that they did not make the tools they used to build it, nor did they personally grow, mine, or manufacture the materials the house was made from.

2
In part, the high transportation costs were likely responsible for tariffs. Merchants required safe cities along their trade routes, and that safety – in the form of a city guard, weaponry, wall repairs, and some form of judiciary – needed to be paid for. Large distances required lots of intervening stops and lo, tariffs.

National governments are not concerned about the *global* standard of living, however. And therein lies the rub. Both developed countries with large domestic markets and developing countries attempting to develop their own industries have an incentive[3] to unilaterally adopt some degree of protectionist policies. Today, the United States seems intent on acting upon that incentive through the enactment of trade tariffs.

The Economics of Tariffs

Trade tariffs are just a sales tax applied to imports (generally of goods). They unavoidably raise either prices for consumers or costs for producers and, in so doing, decrease the total amount of trade that occurs. If a taxed good becomes more expensive, consumers must either purchase less of it or have less money to spend on other things. If producers lower prices to accommodate the tax, they must compensate by reducing investment spending, their wage bill, or distributions to shareholders. In each case, the result is a loss in trade. Put simply: trade tariffs lower global economic growth.

Proponents of import tariffs still exist – even outside the White House – and they tend to support tariffs under some combination of the following economic arguments:

1. The trade loss is in large part absorbed by the taxed country.
2. The revenue from tariffs can help reduce *domestic* taxes (or boost government spending).
3. The local economy benefits from the (re)development of an industry that would otherwise be smaller or not exist.

This gives us a blueprint for the best-case economic scenario for a tariff. For Argument #1 to hold, the deadweight loss of tariffs must be incurred by foreign producers. This will only happen if these producers find that absorbing the tariffs (by lowering the prices they charge consumers) is a profit-maximizing endeavor. Under this scenario, local consumers buy roughly the same amount of the tariffed good (because after-tax prices didn't increase by much), and the government sees a revenue increase, allowing for Argument #2 to come into play and more than make up for any consumer loss that occurs. In the medium term, Argument #3 ensues as the ROI of producing the tariffed good *locally* looks better than producing it elsewhere, particularly if the government subsidizes production with part of its higher revenue. In the ideal case, this production uses spare resources in the economy (such as people who want a job but don't have one) and exhibits increasing returns to scale (where the more goods you produce, the lower your average cost per good).[4] This means that domestic production will go up, and local consumers will eventually get the tariffed good at *lower* prices. A win-win-win.

Though this protectionist dream might come true in a vacuum, it generally falls apart in a world with gravity, friction, and spite. To begin with, the sequence of positive outcomes described above relies on the taxation of a specific, narrow set of goods. As the economist-cum-blogger Noah Smith observed some time ago,[5] the only case in which you escape an exchange rate adjustment to tariffs is when those tariffs are *targeted.* When applied *broadly,* however, currencies tend to immediately respond to bring the trade balance back in line with the desired flow of capital (more to come on this in Part 2). A strengthening currency will help blunt the impact of tariffs on local consumers, but it will most certainly hurt domestic exporters.

Argument #1 is also reliant on consumers being extremely price sensitive (or "demand elastic," in economic parlance). When they are not – whether because the imports in consideration are necessary for their production process (car manufacturers can't forego steel, for instance) or for their survival (New Englanders need natural gas to heat their homes) – the local economy feels the pain. The government might be able to ameliorate this by deploying the tariff revenue efficiently (Argument #2), but to believe the offset would be complete would require staunch faith in our central planners.

3
More of a *political* incentive than an economic one.

4
Under increasing return to scale, crushing foreign competition to create a national monopoly is in fact a (domestic) positive from tariffs (or quotas) that can be hard or impossible to achieve without intervention.

5
https://www.noahpinion.blog/p/why-targeted-tariffs-are-more-effective

Then, of course, there's retaliation. If you pick a fight with a smaller country that is entirely reliant upon yours, perhaps it can be avoided. If you pick a fight with *everyone,* someone might recall the basic game-theoretical result that, in repeated interactions, punishing selfish actors is the best way to ensure broader, long-term coordination. Also, people are spiteful. Unilateral tariffs are universally viewed as unfair, and both social science research and indeed the broad history of civilization show that people are generally prepared to compromise their own welfare to retaliate against those they believe have treated them unfairly. Retaliation ensures that domestic exporters, and through them domestic production, suffer in a trade war.

Arguments #1 and #2 are therefore unlikely to justify the use of tariffs. That said, the most common reason for tariff enthusiasm is Argument #3 – that tariffs will spur domestic manufacturing by making international purchases unattractive. This is not a novel idea, and it has been tried over time by many a developing country through import tariffs and quotas, with occasional success (e.g., South Korea) and rather more frequent disappointment (e.g., basically every country in South America). It has seldom been tried by a developed nation, however.

And frankly, for good reason. If you have a rich, growing economy where the return on investment for your knowledge industries is high and the domestic provision of low-skilled services is well-compensated, it isn't obvious that you're missing out by *not* having a large manufacturing footprint. It is all the less obvious when you're able to run a massive trade deficit in order to import what you don't locally produce and your currency keeps appreciating. To the contrary, if foreigners are satisfied to give you physical stuff that you value today for the right to own bonds and equities that give them claims to your public and private cashflows in the future (claims that are currently really expensive, by the way[6]) the implication is that – at least relative to the rest of the world – your economy is on the right track.

For the U.S. to redevelop its manufacturing industry, it would either need to source labor and capital from other sectors of the economy or make work (and investment) attractive to labor and capital that is otherwise idle. In the first case, the reallocation of resources would lead to an economic improvement if – and only if – manufactured goods are valued more highly by the world than the goods and services currently produced with those same resources. If they are *not,* the workers (and capital) deployed in manufacturing would become poorer, with economic output growing below potential. Given that a competitive system which incents profit-maximization tends to allocate resources close to efficiently, it is hard to argue that *broad* government intervention is likely to boost economic output. As for idle resources – it is unlikely that they are plentiful in the U.S. (the employment-to-population ratio in the U.S. is above the 85th percentile for essentially every age cohort over 25). Moreover, it is far from obvious that idle labor would be attracted by jobs that can afford them *less* than those that are currently on offer in a competitive capitalist system. It is therefore quite hard to argue for broad trade tariffs on the expectations of improved economic outcomes alone.

Redeveloping manufacturing in the U.S. could be justified on *non*-economic grounds. If the government is concerned about national security, or if they have a belief that factory jobs are inherently better for laborers' welfare and social cohesion, then tariffs might indeed be a useful instrument to enact change. A rational attempt to use tariffs to improve national security or produce jobs that are in some way "superior" to those that stem from a competitive capitalist system should, however, aim to do so in a manner that minimizes the economic cost of this anti-economic decision. This means imposing tariffs in as limited and targeted a manner as possible. A broad application of tariffs would, as we have stated, lead to much larger economic losses than necessary to achieve a revival of specific American manufacturing capabilities.[7]

6
It is hard to overstate how skewed this trade is to America's advantage at the moment. The U.S. dollar is trading near its all-time highs on a purchasing power parity basis, which means the U.S. dollars foreigners get in return for their exports buy far less U.S. goods and services than the currencies they traded for them do in their own economy. And insofar as they are not just buying U.S. dollars, but also U.S. assets, U.S. stocks are currently trading at their largest premium to non-U.S. stocks on just about any valuation metric one could name. Meanwhile those foreigners buying U.S. credit instead of equities are doing so at spreads that are close to all-time tights. When people are falling over themselves to trade with you on terms that are fantastically favorable to you, it does seem a little counterproductive to try to stop them from doing so.

7
For national security purposes, it seems uniquely counterproductive to place broad tariffs on Mexico and Canada, our geographically closest allies, who can help with the (cheap) production of many goods that we do not produce ourselves.

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Conclusion

At the end of the day, almost any government policy has costs along with its benefits. Of course, tariffs are no exception to this. The more revenue tariffs raise, the more costs they impose on consumers. If tariffs succeed in restructuring the U.S. economy, that restructuring will both reduce the amount of revenue that tariffs raise and, in all likelihood, reduce the aggregate productive capacity of the U.S. economy as capital and labor get redeployed to areas where they are less productive than they would be given freer trade. The clearer and more specific the goals of a trade policy are (for example, ensuring the U.S. has enough productive capacity of steel and aluminum either domestically or from reliably friendly allies to withstand a major war), the more cost-effectively we can attempt to achieve those goals. But trade has been an amazing enabler of human and economic progress and restricting it has significant costs. Pretending that the benefits of restricting trade can come without meaningful costs is a fantasy that will likely wind up costing America (and the world) dearly.