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**The economic damage from a trade war**

*Economists are taught trade wars are almost always damaging. The question for investors is: how damaging?*

By Gavyn Davies

President Donald Trump’s threatened **escalation** of trade **tariffs** has moved to the center of investor concerns. So far, the **levies** announced on steel and aluminum imports affect sectors so small that they will have almost no macro effect on US inflation, growth or employment. However, they could represent the thin edge of a very large wedge.

The focus now shifts to the **Article 301 investigation** into China’s practices in technology transfer and **intellectual property**. The White House is likely to take action on that soon. With hawks like Peter Navarro and Wilbur Ross in the **ascendancy**, and modifying influences fading after Gary Cohn’s resignation as chief economic adviser, the president may soon follow his instincts and announce tariffs on imports from China.

Although Navarro and Ross see tariffs as a means of forcing Beijing to abandon unfair **distortionary** practices, they could just as easily result in retaliatory trade controls, and even a global trade war. That may seem improbable, but hostile **rhetoric** is building, and such an outcome can no longer be ignored.

This week, I will discuss the **analytics** of trade tariffs, and their macroeconomic impact on the country that imposes them. . . .

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The bottom line: a global trade war, though still unlikely, would **administer** a negative shock to world GDP of perhaps 1-3 percentage points in the next few years. Although investors might see this as a manageable hit to growth, there is a downside to the distribution that could turn out to be much worse.

Economists are taught early on that trade wars are always damaging. Memories of the **Smoot-Hawley Act in 1930** loom large. But what are the mechanisms involved?

When tariffs are imposed, the increase in the costs of **cross-border trade** obviously reduces global imports and exports, relative to output. This is what drives the welfare gains and losses in the longer term.

On this, there are some centuries-old results from international trade theory (see the leading textbook by Paul Krugman *et al*). In these partial equilibrium trade models, almost no one disputes that the decline in trade flows will reduce the scope for the **law of comparative advantage** to work, and for technology to flow easily across borders. . . .

Further cases that may justify tariffs are the protection of **infant industries**, and the correction of **market distortions** (*e.g.* export **subsidies**) imposed by other governments. However, most economists think it is better to attack these distortions head on, rather than indirectly through “offsetting” import tariffs.

Moving into macro-economics, many variables can change in response to tariffs, including the exchange rate, inflation, monetary policy and unemployment. This becomes much more complicated. In old-fashioned **Keynesian** models (with fixed prices and exchange rates), a tariff is viewed as an **expenditure**-switching **intervention**, not necessarily an expenditure-reducing one. US tariffs on steel imports could cause an increase in domestic production as foreign products are priced out of the American market. As a gross over-simplification, expenditure is, in the first instance, switched from China to the US, leaving global steel production unchanged. Mr. Trump seems to believe all this.

But the effects on aggregate demand are complex. When the US imposes its tariff, China at first loses net income. In the US, steel producers might gain from greater output, but consumers, both households and other companies, lose. The government gains from tariff revenues, though these are probably distributed across the economy.

The initial effects on aggregate demand therefore depend on how all these gains and losses are **translated** into expenditure. Such redistributions are similar to the effects of an oil price increase that shifts income away from consumers and towards producers. If the losers cut demand immediately, while the winners spend their gains more slowly, global demand and output will fall in the short term. But none of this is obvious without much more **empirical** work.

**Mercantilist** elements in Keynesian policies are definitely inapplicable to countries [with flexible exchange rates] . . . Tariffs worsen employment and output. Robert Mundell, 1961 In his classic 1960s work, Robert Mundell argued that, in a world of **flexible exchange rates**, a new US import tariff will tend to improve the country’s **trade balance**, which will increase the dollar’s **real exchange rate**. This real exchange rate rise dominates the effect on the American economy, producing an overall decline in US output and employment, despite the (smaller) gains from the tariff’s expenditure-switching effect.

This remains the standard result. Maurice Obstfeld, the International Monetary Fund’s chief economist, wrote in 2016 that a 20 per cent US tariff on imports from East Asia, would (without retaliation) raise the dollar by 5 per cent, and cut US output by 0.6 per cent over five years.



In these models, Mr. Trump’s trade agenda could backfire on the US economy. Furthermore, all these results would be worse if we allow for temporary effects of tariffs on global supply chains, which could disrupt production, and the damage to confidence from uncertainty about trade policy. These effects **skew** the possible outcome markedly towards the downside.

And there is the danger of **retaliation** from trading partners. Next time, I will try to quantify these serious global threats.

**Glossary**

**administer** – manage and be responsible for the running of something.

**analytics** – the systematic computational analysis of data or statistics.

**Article 301 investigation** – measure within NAFTA that allows to look into any allegations of trade restrictions or trade barriers.

**ascendancy** – occupation of a position of dominant power or influence

**comparative advantage** – refers to an economy's ability to produce goods and services at a lower opportunity cost than that of trade partners.

**cross-border trade** – The buying and selling of goods and services between businesses in neighboring countries, with the seller being in one country and the buyer in the other country

**distortionary** – any departure from the ideal of perfect competition that therefore interferes with economic agents maximizing social welfare when they maximize their own

**empirical** – based on, concerned with, or verifiable by observation or experience rather than theory or pure logic.

**escalation** – an increase in the intensity or seriousness of something; an intensification

**expenditure** – another term for “spending.”

**flexible exchange rates** – exchange rates determined by global supply and demand of currency, not controlled by central banl.

**infant industries** – a new industry, which in its early stages experiences relative difficulty or is absolutely incapable in competing with established competitors abroad.

**intellectual property** – a work or invention that is the result of creativity, such as a manuscript or a design, to which one has rights and for which one may apply for a patent, copyright, trademark, etc.

**intervention** – the action of interfering in some function of the economy.

**Keynesian** – person who believes that aggregate demand is influenced by a host of economic decisions—both public and private—and sometimes behaves erratically.

**levies** – taxes

**market distortions** – scenario that occurs when there is an intervention in a given market by a governing body. The intervention may take the form of price ceilings, price floors or tax subsidies.

**mercantilist** – person who follows a national economic policy that is designed to maximize the exports of a nation.

**real exchange rate** – how much the goods and services in the domestic country can be exchanged for the goods and services in a foreign country.

**retaliation** - the action of harming someone because they have harmed oneself; revenge.

**rhetoric** – the art of effective, persuasive speaking or writing, especially the use of figures of speech.

**skew** – suddenly change direction or position.

**Smoot-Hawley Act** – also known as the Tariff Act of 1930, raised tariffs to the highest levels in American history, attempting to help domestic production in the United States, but had the opposite effect—dramatic failure of American businesses.

**subsidies** – a sum of money granted by the government or a public body to assist an industry or business so that the price of a commodity or service may remain low or competitive.

**tariffs** – taxes on imported goods

**trade balance** – also known as the balance of trade (BOT), it is the calculation of a country's exports minus its imports.

**translated** – move something from one place to another.