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MACROCOSM

Getting Away With an Act of Tariffism

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Donald Luskin

Has the stock market just taught Trump that "trade wars are good and easy to win"?

It might have been easier if a sharp decline in the stock market had shamed President Donald J. Trump into dropping the idea of steel and aluminum tariffs. But as of this writing the S&P 500 is actually up a bit – about 1.5% – since month-end, just before the tariffs were suddenly announced.

- *We think it's worth considering that Mr. Market has in fact judged that adjustments to the terms of global trade, aggressively negotiated but judiciously applied, are a positive for growth.*
- *But even if that's true, it implies opening a door to a whole new world of both opportunity and risk – the opportunity to re-engineer helter-skelter globalization that has dealt a severe trade shock to the developed world, and contributed to an era of "secular stagnation," but at the same time, the risk of catastrophically disrupting large and deeply-rooted economic structures that have adapted to deal with it over the better part of a generation.*
- *The market gave Trump permission to charge through that door.*
- To be sure, the market's small positive reaction, on net, could be purely illusory. Perhaps without the tariffs, stocks would be even higher, since they were already in the process of bouncing back from the VIX-driven mini-crash of early February (see "Inside the VIX Engine of Destruction" February 8, 2018). And this morning's jobs report didn't hurt (see "Data Insights: Jobs" March 9, 2018).
- But according to sources who claim to know, the market's sharp negative reaction when the tariffs were first previewed last week alarmed the White House – which had bragged continually about last year's rally – and was a particular embarrassment to Commerce Secretary Wilbur Ross.
- We said last week that the harsh and sweeping initial proposal was only the classic "big ask" negotiating gambit, a classic Trump "art of the deal" move (see "Tariffs: How Scared Should We Be?" March 2, 2018). We said the tariffs would get watered down, and indeed they were – *exempting Canada and Mexico cuts out more than 30% of the dollar value of the tariffs* which are, effectively, a tax on American consumers. Intense pushback from the president's own party and National Economic Council head Gary Cohn's furious efforts before leaving in a huff had a lot to do with that, but no doubt a week of stock market volatility did, too.
- Now, with yesterday's watered down proclamations ordering steel

Update to strategic view

US MACRO, US STOCKS: Watered-down tariffs on steel and aluminum go into effect in two weeks. The exemption of Canada and Mexico takes out 30% of the tax-hike effect. The stock market is slightly higher than when the tariff crisis began last week, perhaps signaling approval of the way it turned out – but in any event giving Trump permission to go further along these lines. The Trump process of decision, negotiation and persuasion looks more chaotic than it is. Re-engineering the terms of global trade has a positive and high expected return, but it is risky because it threatens large existing economic structures. The low-hanging fruit of de-regulation and tax cuts has already been picked. Now comes the high-hanging fruit, and the risk.

[Strategy dashboard]

and aluminum tariffs, Trump seems almost reasonable about it all – even though all he did was moderate his own prior unreasonable views. It's another classic Trump move – "pacing and leading," in which he first establishes credibility with a key constituency (in this case, the "economic nationalists") by adopting an extreme form of their views, and then having earned their trust, leads them to a more nuanced position that is acceptable outside that constituency.

- While it's happening, it looks like pure improvisation and downright chaos. It can be just plain goofy, as when Trump said Tuesday that tariffs would be applied "in a very loving way. It will be a loving, loving way. They'll like us better…"
- Yet over and over it works for Trump.
- *Suddenly, it even seems to be working in solving the existential problem of North Korea's nukes*, with Trump's seemingly reckless "fire and fury" remarks of last year having, in fact, produced a path that seems to lead precisely to the negotiated solution (nukes for regime-security) that we predicted (see "Debt! NoKo! Irma! DACA! Cohn! …and Other 4-letter Words" September 7, 2017).

So here's where we think we are. It both encourages us and scares us.

- We won't repeat here all our arguments for why the structure of global trade urgently needs repair – an urgency reflected in radical political developments such as Brexit and Trump. Suffice it to say that we don't believe that all trade is always good under all conditions and in all times and places. It can create negative externalities that swamp its benefits (for a fuller explication, see "Tariffs: How Scared Should We Be?" March 2, 2018).
- *But government interventions to fix the problem are very dangerous, because they threaten important existing structures.*
- Trump's first year in office was spent very effectively addressing the problem in ways that entailed no risk. De-regulation and cutting too-high corporate taxes are straightforward ways to make America more globally competitive, and they produce all winners and no losers. *They are the low-hanging fruit.*
- But the easy and riskless parts are over. *Now comes the high-hanging fruit, which is very dangerous to try to pick.*
- Next-up is an attempt to deal with the bilateral US-China trade relationship, in which the US currently runs a $375 billion annual deficit. We don't believe that simply having a trade deficit means a nation is "losing" – but on the other hand, one this large suggests at least the possibility that trade liberalization by China could close the gap by admitting more US exports.
- Trump tweeted on Wednesday that he has asked China to produce a plan to reduce its trade surplus with the US by $1 billion per year. That's classic Trump, by the way. He makes a seemingly stupid error, in this case channeling Dr. Evil (it's $100 billion, not $1 billion) – and while the media flips out about what a know-nothing he is, that just creates more attention for

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Recommended Reading

Does President Trump Know What a Radical Environmentalist He Picked in Peter Navarro?
Colin Flaherty
American Thinker
March 6, 2018

Economic Forecasts with the Yield Curve
Michael D. Bauer and Thomas M. Mertens
FRBSF Economic Letter
March 5, 2018

[Reading home]

the policy proposal than it ever could have gotten otherwise.

- It would seem to be a generous negotiating framework – giving China a chance to determine its own optimal solution and propose it to us. But at the same time, China knows full well that the US Trade Representative, at Trump's behest last August, has been hard at work conducting an investigation under Article 301 of the Trade Act of 1974, which seems destined to conclude that China is a major abuser of US intellectual property, which in turn could lead to the imposition of – you guessed it – tariffs.
- *It's not fair, nor analytically helpful, to call this a "trade war." This is a time of legitimate re-examination and re-engineering of trade relationships that we blundered into after the end of the Cold War and through the industrialization of China.*
- *But make no mistake about it. Trump is engaged in this. He was elected to do it.* Hopefully he'll continue with his unique combination of bluster on the one hand, and a seemingly chaotic "team of rivals" in the White House that moves him ultimately toward moderation. Who replaces Cohn will be a powerful signal of whether this ultimately beneficent pattern can continue.
- *This project has a positive and high expected return, and for now we expect positive outcomes. But like so many things about which that can be said, it is very risky.*
- *We've enjoyed a prolonged period of low risk while the low-hanging fruit was being picked. That's over. This will not only be a test of the skill of the negotiators of the nations of the world, but of the risk-tolerance of markets.*
- *The renaissance of risk-tolerance has been the hallmark of the latest leg in the global bull market* (see, among many, "2017: It's Bigger than The Donald" December 30, 2016). *Now we'll see how deep it runs.*

Bottom line

Watered-down tariffs on steel and aluminum go into effect in two weeks. The exemption of Canada and Mexico takes out 30% of the tax-hike effect. The stock market is slightly higher than when the tariff crisis began last week, perhaps signaling approval of the way it turned out – but in any event giving Trump permission to go further along these lines. The Trump process of decision, negotiation and persuasion looks more chaotic than it is. Re-engineering the terms of global trade has a positive and high expected return, but it is risky because it threatens large existing economic structures. The low-hanging fruit of de-regulation and tax cuts has already been picked. Now comes the high-hanging fruit, and the risk.