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INTELLECTUAL AMMUNITION

Sympathy for the Tariff Devil

Friday, May 17, 2019

Donald Luskin

It's probably a ploy, but if not, this is no Smoot-Hawley. The real risk is Chinese recession.


Donald J. Trump @realDonaldT... 2h
In one year Tariffs have rebuilt our Steel Industry - it is booming! We placed a 25% Tariff on "dumped" steel from China & other countries, and we now have a big and growing industry. We had to save Steel for our defense and auto industries, both of which are coming back strong!

In a series of tweets over the last week, President Donald J. Trump has sought to normalize tariffs as a permanent feature of US economic policy, positioning them as a powerful, positive pro-growth tool. As usual, Trump's simplistic and provocative tweets – brazenly flying in the face of economic orthodoxy – have triggered the mainstream media to assume the worst, as it is always eager to do with Trump. And as usual, this is useful to Trump, as it lends heft and credibility to what is likely only a threat-posture. It is likely only a ploy designed to bring China back to trade negotiations in a position of submissiveness, fearing that it must offer an especially compelling deal to dislodge US tariffs that Trump now sees as intrinsically valuable. Such a ploy won't work if China thinks it's just a ploy. Trump's game is to make China think it's real – which necessarily means making markets think it's real, too. At the moment, China says it will not negotiate under such a threat – which means is taking it seriously. *So we must ask: what if it is really real? What if these tariffs are permanent?*


The New York Times
Late Edition
Today, mixture of clouds and sunshine, milder, high 65. Tonight, cloudy, showers, low 54. Tomorrow, showers to start, partly sunny, high 68. Weather map is on Page B12.
... No. 58,328 + © 2019 The New York Times Company NEW YORK, WEDNESDAY, MAY 15, 2019 $3.00

QILAI SHEN/BLOOMBERG

Some in China Fear Severing Ties With U.S.

Say Both Sides Benefit From 'Chimerica' Bond

By LI YUAN

Wu Shichun is one of countless Chinese entrepreneurs who over the past four decades have prospered from access to American customers and money.

THE NEW NEW WORLD

Today, as the American government threatens to take that away, Mr. Wu, a serial entrepreneur and venture capital investor, is fundamentally rethinking how he does business.

One of his portfolio companies designs and makes fashion products in China, then sells them to American consumers on Amazon.com. Another, a vape device maker, sells most of its products in the United States. The third, which makes metal materials for electronic manufacturers, ex-

TARIFFS MAY STAY IN TRADE TOOLBOX AS U.S. REFOCUSES

AUTOS ARE NEXT TARGET

Trump Lifts Rates to the Highest Levels in the Developed World

By ANA SWANSON

WASHINGTON — President Trump's tariffs were initially seen as a cudgel to force other countries to drop their trade barriers. But they increasingly look like a more permanent tool to shelter American industry, block imports and banish an undesirable trade deficit.

More than two years into the Trump administration, the United States has emerged as a nation with the highest tariff rate among developed countries, outranking Canada, Germany and France, as

Update to strategic view

US MACRO, ASIA MACRO, FX: Trump appears to be normalizing tariffs as pro-growth economic policy. This is likely a ploy to bring China back to trade negotiations. But if Trump is sincere, and tariffs on Chinese exports become a permanent fixture, they should not be conflated with deadly tariff episodes in the past such as Smoot-Hawley. Tariffs are just taxes – "sin taxes" designed to alter behavior. In this case, reducing trade with China may well be a positive net present value undertaking, especially for underdiversified firms like Apple. Thanks to yuan weakness, China effectively pays for the tariffs, and funds a war-chest with which the US Treasury can make trade-adjustment payments to victims of Chinese retaliation. If the next round of proposed tariffs kicks in, we expect significant further RMB weakness. The real risk of tariffs is their effect on Chinese growth, possibly triggering a first-ever recession, perhaps a hard-landing that would trigger a global recession.

[Strategy dashboard]

We are trained to believe that tariffs are especially pernicious economic policy. That belief runs deep, because it's deeply cultural: the Smoot-Hawley tariff of 1929, and its role in triggering the Great Depression of the 1930s, is the snake in the Garden of Eden in the fundamental creation-myth of modern US economics.

- *But tariffs are just taxes. If you want to have a government, and if you want to pay for the government you want to have, then you have to have taxes. All taxes entail economic costs: distortion of incentives, deadweight losses and the potential for government corruption. Tariffs, like any tax, need to be understood in the context of an optimization, a trade-off, that seeks to maximize revenues subject to minimizing those costs.*

Click to watch short video about Hamilton's tariff policy

[All videos]

- Tariffs were thought to be optimal at our nation's founding, with the first Treasury Secretary, Alexander Hamilton, advocating in his 1791 *Report on Manufactures* that the US protect its infant industries with tariffs, and use the revenues to build infrastructure to empower those industries (see "Video: What you're not hearing about tariffs, Trump and Alexander Hamilton" May 10, 2019). *So it's not like there is no case at all to be made for tariffs.*
- *And the particular tariffs we are talking about right now – targeted at China – are a very specific case that has to be analyzed on its own unique merits.*

THE CHINA TARIFFS ARE DESIGNED TO DISTORT INCENTIVES IN A PARTICULAR WAY THAT MAY BE GOOD

- *Any tariff is a "sin tax,"* like the taxes on cigarettes – designed not just to raise revenues, but more to reduce behavior deemed by the government to be bad, or at least to compensate society for its associated externalities. In this case, Trump has decided it is sinful – or, on balance, harmful – for Americans to buy things from China. To the extent that he is right, and if the tax-rate is set correctly, the tariffs may actually be a positive net present value proposition. They may set a bad precedent – but that doesn't mean that they may not be, in fact, exactly the right thing to do.

- *Tariffs are designed not to be paid, at least not in full.* If you respond to the incentives and buy from, say, Cincinnati instead of China, then you don't pay the tariff at all. Or at least all you pay is the difference between the presumably lower cost of goods from China and the higher cost from Cincinnati. So while it may seem like a 25% tariff on $500 billion of Chinese goods is a deadweight tax cost of $100 billion, that is in fact only a maximum.
- *Indeed, US companies have probably become detrimentally reliant on China.* It's been greedy and foolhardy for companies like Apple to single-source their manufacturing to China, flouting axiomatic principles of prudent diversification. In such cases, bearing higher nominal costs in the short-term – and avoiding the tariffs, by

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Tom Hancock
Financial Times
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How 'Drunk Shakespeare' Became a Stage Franchise
Cara Joy David
New York Times
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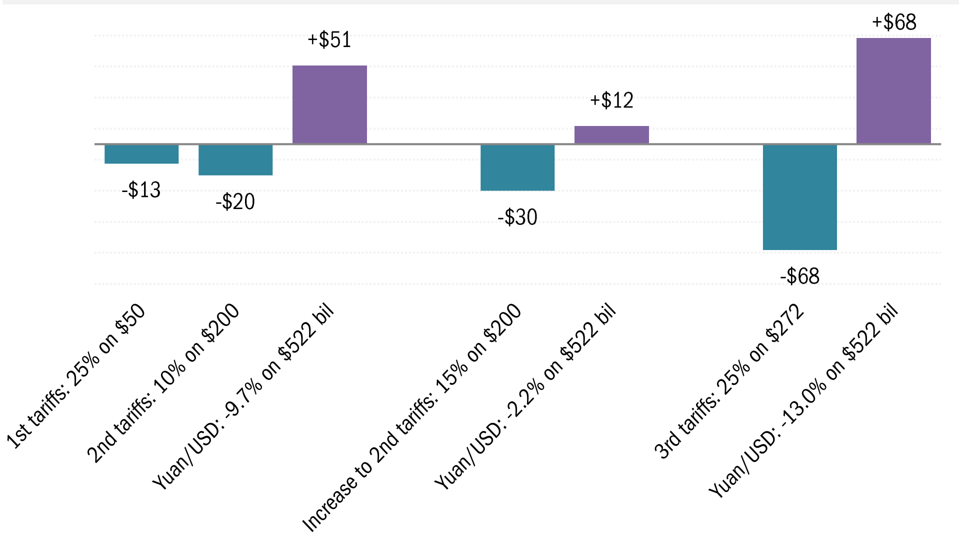
diversifying manufacturing [into, say, India](#) – may well raise the risk-adjusted present value of Apple's enterprise.

THE "INCIDENCE" OF THE TARIFFS DOES NOT FALL UPON THE US BUYER OF CHINESE GOODS

- *A tax is not necessarily borne by the person who writes the check to the Treasury* – for example, the employer portion of Social Security taxes may not be borne by employers, but indirectly by employees in the form of lower wages. In the case of the China tariffs, *much of the cost will be borne by China through weakening of the Chinese currency*. Already, since the tariffs were first announced in April 2018, the yuan has weakened enough to more than compensate for the first two rounds of tariffs, and a mere 2.2% further weakening would compensate for the recent increase of the tariff rate in the second round from 10% to 25% (please see the chart below). A further weakening of 13% would compensate for the possible next round of tariffs capturing the entirety of US purchases of Chinese exports.

Per annum tariff costs, versus yuan depreciation, USD billions, from April 2018 announcement



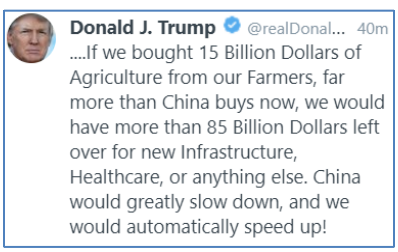
Source: Bloomberg, TrendMacro calculations

- *If that next round of tariffs kicks in, we would fully expect to see such a weakening in RMB*.
- While the weaker yuan holds US buyers harmless, by offsetting the tariffs, *the tariffs are nevertheless paid to the US Treasury, building a war-chest that can be used for trade-adjustment payments, or any other purpose*.
- From the Chinese perspective, a weaker yuan means a stronger dollar. That raises the cost of US goods in China, effectively an automatic retaliatory tariff. But that comes at the price of higher inflation, and the risk of even more capital flight, which may require even more restrictive capital controls.
- We are fully aware that this high-level analysis is incomplete. It is limited to first-order effects, and treats US buyers only in the

aggregate, without distinction between winners and losers among them. We acknowledge there are [empirical] [studies] that conclude costs have already been borne by American buyers, and we thank the client who pointed them out to us. But we are respectfully skeptical of such studies. In any politically charged issue – such as, say, the minimum wage – there are always end up being seemingly authoritative studies that point [both] [ways]. We stand by our analysis as at least being generally and directionally correct.

<u>CHINA IS IN A POOR POSITION TO RETALIATE</u>

- One of the elements that makes us reflexively fear tariffs is the risk of a vicious cycle of retaliation – the doom-loop by which Smoot-Hawley plunge the world into the Great Depression. That is unlikely in the present case.
- The large US trade deficit with China – the $114 billion value of our *exports to* China is less than a quarter of the value of our $522 billion of *imports from* China – means <u>*we have more to tariff than they do, and they have more to lose*</u> from a diminution of bilateral trade.
- <u>*And China's state-owned or state-controlled buyers of US goods would only be paying tariffs to the state anyway*</u>.
- <u>*Within the domain of tariffs themselves, there's just not that much that China can do to retaliate*</u>.
- Those state-owed or state-controlled buyers could boycott US goods, especially fungible commodities such as agricultural products – as they did briefly last year. <u>*But unless and until global supply of those products increases by the amount of the boycott, Chinese purchases of soybeans from, say, Brazil instead of the US, would only crowd out existing buyers, who would have to first be outbid (raising costs to China) and then come to US sellers.*</u>



- To the extent that such an equilibrium of substitution is imperfect, the <u>*US could offer trade-assistance to US producers from its war-chest of billions of dollars in tariffs collected, which effectively would be paid for by China*</u>.
- <u>*To be sure, China's most effective form of retaliation would be to strand US assets by harassing – or even forcibly closing – US factories or other productive assets on Chinese soil*</u>. Other than on a minor symbolic scale, we see anything along these lines as very unlikely, because of the extremely high economic and reputational costs – though in the heat of the moment, it's possible mistakes might be made.

<u>IS THERE *ANYTHING* BAD ABOUT THE TARIFFS?</u>

- Yes. Of course. Among other well-known shortcomings, all tariffs shield domestic producers from the rigors of competition, and tend to make them less dynamic and productive.
- <u>*But in this case the big risk is that the tariffs on China may do their*</u>

job too well. With these tariffs we are courting the risk of throwing China into an economic hard-landing, which could have strong negative spillovers into the global economy.

- *If the tariffs are a means of pressuring China in the trade negotiations, then the only way they could possibly be effective as a threat is if they posed a risk to Chinese growth – by damaging China's export economy, and putting pressure on its currency and courting capital flight.* China admits they are a risk, having called them last October "a knife at its throat" (see "Our Knife at China's Throat" October 8, 2018). Then, as now, they refused to negotiate because of the tariffs. But because the threat was effective, they ultimately had to negotiate, as we believe they will again now. *Indeed, that is probably really the whole point of the tariffs, as we have been saying all along* (see "Is Trump Really Bluffing on Tariffs?" June 22, 2018).
- But enough pressure on Chinese growth, and there could be a recession in China, arguably its first ever. *We are highly skeptical that attempts to stimulate the Chinese economy with accelerated injections of state-sponsored credit can do anything but delay the inevitable reckoning, probably worsening it when it does come.* No one knows what a recession would look like in a debt-burdened command-and-control surveillance-state that hasn't had one in forty years. It could be a very hard landing. Wall Street economists are finally beginning to come around to our view on this, which we have held for a long time (see "Did China Just Run Up the White Flag in the Trade War?" July 10, 2018). We think they are underestimating the potential damage. As a key engine of global growth, a long and deep recession in China would surely trigger a global recession from which the US would not be exempt.

Bottom line

Trump appears to be normalizing tariffs as pro-growth economic policy. This is likely a ploy to bring China back to trade negotiations. But if Trump is sincere, and tariffs on Chinese exports become a permanent fixture, they should not be conflated with deadly tariff episodes in the past such as Smoot-Hawley. Tariffs are just taxes – "sin taxes" designed to alter behavior. In this case, reducing trade with China may well be a positive net present value undertaking, especially for underdiversified firms like Apple. Thanks to yuan weakness, China effectively pays for the tariffs, and funds a war-chest with which the US Treasury can make trade-adjustment payments to victims of Chinese retaliation. If the next round of proposed tariffs kicks in, we expect significant further RMB weakness. The real risk of tariffs is their effect on Chinese growth, possibly triggering a first-ever recession, perhaps a hard-landing that would trigger a global recession.