Economics
Macro news

PROPOSED TARIFFS, POLITICAL DISCORD, AND MARKETS

Markets do not like uncertainties and misguided economic policies. President Trump's proposal to impose tariffs on imports of steel and aluminum products is clearly bad economics, and, fueled in part by some of President Trump's off-the-cuff remarks, uncertainties and risks have been elevated by media headlines that speculate on the possibility of "trade wars" and now the resignation of Gary Cohn, Chairman of the National Economic Council (NEC).

As we described in a brief last week in direct response to Trump's announced proposals ("President Trump's Proposed Tariffs on Steel and Aluminum: The Economic Implications of Wrong-Headed Policies", March 1, 2018), in light of the small amount of U.S. imports of steel and aluminum products (in 2017, $29 billion and $17 billion, respectively) relative to all imports, the direct economic impacts on economic performance and jobs would be relatively small. However, we emphasized that the risk is if mounting uncertainties jar confidence that harms consumer spending and business investment. We put a low probability that there will be a larger macroeconomic impact. We expressed frustration that, in the context of very positive economic effects of elevated confidence stemming in part from the thrust toward reducing burdensome regulations and anticipated healthy responses to the Tax Cuts and Jobs Act, the proposed tariffs are misguided and their timing is decidedly poor.

Cohn's resignation from the NEC highlights the rancor of the debate within the Administration and seemingly raises uncertainties and risks of policy deliberations. Internal debates about trade and tariffs have a history of being heated and divisive. Trade barriers have been threatened and erected before on the same scope as Trump's proposal, and while their impacts have been negative, the world did not unravel.

Markets tend to react to news in simplistic ways: the perception is that there is Trump + Ross + Navarro pushing for trade protectionism…and there was Cohn who argued against the protectionist measures… and now he is gone. True, Cohn was the key point person on bringing a rational view on trade, but he is certainly not the only person in the Administration who was involved in the debate and certainly not the only person capable of filling the position of head of the NEC.

Importantly, Congressional leaders are taking a strong stand against the tariffs, and many businesses are lobbying against them. Most likely, these efforts will result in a modification of the tariffs and some surgical exceptions.

*In our brief, we emphasized that Congress (specifically, the House Ways and Means, and Senate Finance Committ***ees) has jurisdiction over tariffs, and President Trump's** *tariffs were proposed under the auspices of national security* — under Section 232 of the Trade Expansion Act of 1962, which gives the president authority to restrict imports and impose limited tariffs if the Department of Commerce concludes that the current reliance on those imports is a national security threat.

Orrin Hatch, Chairman of the Senate Finance Committee, sent a very pointed letter to President Trump yesterday arguing against the proposed tariffs. *It is noteworthy that the letter was copied to Secretary of State Tillerson, Secretary of Defense Mattis, and General McMaster, National Security Advisor, who manage national security issues. They are all sound-minded and fairly centrist on issues of global diplomacy and trade.*

07 March 2018

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Last week, President Trump stirred the pot on the tariff issue by stating that he is considering tariffs "on European automobiles" and that "trade wars are good and we would win." Some nations mentioned retaliatory measures. Obviously, such rhetoric lifts uncertainties…and economic risks.

Realistically, Congress would step into action if Trump were to overstep his bounds. While the Department of Commerce's study on steel and aluminum gave Trump and Secretary of Commerce Ross the angle on imposing tariffs as a national security issue, it would be a far stretch to consider the importation of autos from Europe ***as harmful to the U.S.'s national security.*** Congress would win the argument and Trump would back off.

Regarding his off-handed comment on trade wars, that is classically Trump, and consistent with his bully behavior and willingness to poke the establishment in the eye. On tax policy, the ACA repeal and reform, and other issues, Trump took extreme stances. He repeated those stances even as negotiations proceeded. Eventually, he back-peddled and compromises were negotiated. The issue of tariffs is trickier, and Trump's instincts are misguided.

His statement that "trade wars are good and we will win" is obviously naïve and misplaced on many dimensions. It reflects his narrow and simple vision that tough negotiations are necessary, and he believes the U.S. has the upper hand. In the context of his career of NYC real estate wheeling and dealing, his statement translates into: "I want to buy that building; let's fight it out and bloody our noses and yell obscenities at each other in public. In the end, I'll get it with many givebacks (or we may buy it jointly), and afterwards we'll have a few drinks."

Most likely, there will be further negotiations and Trump will back-peddle to softer ground with some exemptions and contingencies on the applications of the tariffs.

As for retaliation, we expect more bark than bite. The biggest exporters of steel to the U.S. — Canada (16%), Brazil (13%), South Korea (10%), and Mexico (9%) — will argue strenuously against tariffs but cannot risk antagonizing their largest trading partner. Trump's vision of international trade is naively driven in part by bi-lateral trade imbalances. The U.S. maintains a modest trade surplus with Canada ($3 billion) and a trade deficit with Mexico ($277 billion of exports and $346 billion of imports). Canada is in a bind — it is by far the largest source of U.S. imports of aluminum (43%) — and has already seen its motor vehicle industry erode (Mexico has been a major beneficiary) and relies heavily on the U.S. as a trading partner. It also has some key industries that it heavily protects through tariffs/quotes/other means (timber, dairy) that are being scrutinized in the NAFTA deliberations.

The U.S. has a very large (-$337 billion) bi-lateral trade deficit with China ($187 billion of exports and $524 billion of imports). China exports of steel and aluminum products to the U.S. are minor (2.2% and 9.5%, respectively, of total U.S. imports of steel and aluminum products). It will negotiate with a goal of protecting its economy and not upsetting the global economic order.

Europe, if it does retaliate, would limit its responses (tariffs/trade barriers) to items that would be more symbolic (so far, Harley Davidson, Bourbon whiskey, and orange juice have been mentioned). European economic performance is solid, with healthy growth and declining unemployment. In this context, European leaders would view Trump's tariff threats as more of an irritant and they would avoid irrational responses that may harm their economic momentum and the global economic order.

The U.S. Congress would take effective steps to constrain Trump's tariff proposals that are clearly outside the realm of national security.

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