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INVESTMENT PUBLICATIONS HIGHLIGHTS

DOOMED TO REPEAT IT: THE LONG HISTORY OF AMERICA'S PROTECTIONIST FAILURES

Scott Lincicome, CATO Institute, *Policy Analysis*, Number 819, August 22, 2017

The author analyzes protectionist policies from three periods in American history, finding that they have failed as an economic strategy. On balance, the costs of these policies outweigh the meager benefits they provide to protected industries. While many Americans believe that protectionist policies could revive struggling industries, the author argues that historical evidence is clear on their efficacy.

The first period the author analyzes is from the founding of the United States to its entry into the General Agreement on Tariffs and Trade (GATT) in 1947. Although this period provides few real economic lessons to modern policymakers because of the stark social, legal, and economic differences between then and now, it is full of protectionist blunders. The author examines one of the most cited failures—the Smoot-Hawley Tariff. It accounted for about one-third of the 40% reduction in US imports between 1929 and 1932, which in turn provoked retaliation against US exports. As a result, America's share of world trade fell dramatically in the early 1930s.

The second period the author focuses on is from GATT's early years to the inception of the World Trade Organization (WTO) in 1995. This period also has its fair share of protectionist failures, save the example of the bicycle industry. Protectionist measures made this industry more competitive with imports by modernizing and improving the product. But, US import restrictions between 1950 and 1990 annually cost US consumers an average of \$620,000 in current dollars per each job saved across the protected industries. The author further finds that trade restrictions on clothing, sugar, automobiles, and steel levied the equivalent of a 23% income tax surcharge on US consumers.

The last period of the analysis is the current WTO era in which anti-dumping laws were introduced by the WTO. But, like other protectionist measures, it also failed to act as a viable economic strategy. The author states that the steel industry, which benefited more than any other industry from anti-dumping orders, did so at the cost of steel-consuming industries, which suffered 40–60 job losses for each job saved in the protected steel industry.

The author acknowledges the economy's challenges, as workers deal with automation, innovation, and shifting consumer tastes. He encourages the consideration of new policy ideas to mitigate these challenges, but views protectionist strategies as harmful to the overall economy.

FIVE REASONS WHY THE FOCUS ON TRADE DEFICITS IS MISLEADING

Robert Z. Lawrence, Peterson Institute for International Economics, Policy Brief 18-6, March 2018

The author analyzes misconceptions about trade deficits, arguing that several widely held beliefs are not supported by economic evidence. Moreover, the Trump administration's efforts to reshape trade policy will neither usher in a return of US manufacturing jobs nor will it improve economic growth.

The author first reviews the claim that trade deficits lead to negative outcomes by examining the links between job loss and trade deficits, and the data suggest that larger deficits are associated with faster US economic growth. The data also indicate that a higher level of imports is supportive of total domestic employment. Furthermore, a trade deficit could be a desirable result of trade if the deficit is being used to fund productive investment opportunities. In 2015, foreign direct investments in the United States totaled \$5.6 trillion.

The author then reviews whether the loss of manufacturing jobs is linked to the US trade deficit and discovers trade has been a factor in the decline of US manufacturing jobs, but a small one. A report studying its effects argues that less than 20% of the 5.5 million manufacturing jobs lost from 1999 to 2011 were due to imports from China and other countries. The data showed that rapid productivity growth and relatively inelastic demand for lower priced goods have been the primary drivers of US manufacturing job loss. Additionally, manufacturing was the beneficiary of 41% of the aforementioned \$5.6 trillion in foreign direct investment. Moreover, since the 1970s, manufacturing employment as a share of total employment has been declining for all major industrial countries, even in countries with large trade surpluses.

Common misconceptions on trade extend to trade policies, which many critics blame for the trade deficit. The author contends that for trade policies to materially affect the trade deficit, they must also affect savings and investment, which are driven by more fundamental factors, such as income, interest rates, wealth, and expected future income. Policies supported by trade-deficit critics are unlikely to impact these fundamental factors.

EQUITY MARKET OUTLOOK: TRADING WAR AGAINST GROWTH

Maneesh S. Deshpande, Barclays Equity Research, *Equity Market Outlook*, March 27, 2018

The probability of a trade war has increased in recent months, but it remains a tail risk. S&P 500 company earnings would suffer under a worst-case scenario, with the industrials and energy sectors affected the most. China has the smallest impact on earnings among major trade regions.

Protectionist trade rhetoric turned into policy recently. The Trump administration imposed tariffs on steel and aluminum imports, followed by a back-and-forth exchange of tariff threats with China. Given the resignations of several senior officials seen as moderates, the administration may be more likely to press forward with a protectionist trade agenda. While the authors believe the probability of a full-on trade war has increased, they still view that probability as low.

The 25% steel and 10% aluminum import tariffs are likely to negatively hit the automobile, aerospace, heavy-equipment, and construction sectors the most, though domestic steel and aluminum producers would benefit. On balance, the authors estimate the effect on S&P 500 earnings would be a loss of less than 1%. Major trading partners were later exempted from such tariffs, so the overall impact on company earnings is likely to be minimal.

Under a worst-case trade war scenario in which 10% tariffs are levied against all US imports and exports, the authors estimate that 2018 S&P 500 earnings would fall by 11%. This would offset the bottom-line benefit from the recently passed tax cuts. Importers would be more affected than exporters, reflecting current supply chain exposure to global trade. Among sectors, the industrials and energy sectors stand to lose the most.

Trade with China captures headlines, but it is estimated to be the smallest detractor from S&P 500 earnings among major regions. An isolated trade war with China would negatively impact earnings estimates by 1.2%. A similarly sized trade war with Europe would lower earnings by about 2.5%. US importers would bear the brunt of the earnings decline, given the current US-China bilateral trade deficit, and exporters would be relatively unaffected.

There are several caveats to this analysis. First, the methodology assumes all new costs related to tariffs are absorbed by the companies themselves, implying no pricing power on goods bought or sold. Second, the analysis does not consider the knock-on effects of declines in realized gross domestic product growth relative to expectations. Finally, business sentiment would likely fall as a result of lower GDP growth and overall profitability, a factor which was not incorporated.

MADE IN THE USA . . . OR CHINA? 25 YEARS OF SUPPLY CHAIN INVESTMENT AT A CROSSROADS

Mark Delaney et al., Goldman Sachs Equity Research, March 26, 2017

Trade flows between the United States and China have grown rapidly as both economies have become increasingly interdependent. The authors comment on the overall flow between the two countries, discuss how policy changes could affect trade, and review case studies detailing how three industries could change given a geographic shift in the supply chain.

From 1990 to 2015, investment in China by US companies more than tripled that of the Chinese company investment in the United States. The majority of US investment in China has been in development projects, such as new factories, with Chinese companies typically buying existing US companies. Over the last 25 years, there has been nearly \$300 billion in foreign direct investment between China and the United States. As foreign direct investment has increased, so has the interdependence between the two nations.

If the United States were to enact increased tariffs or border taxes, China would likely respond with similar protectionist measures. China may decide to drop US companies from its state approved purchase list, which would restrict government entities from

buying items sold by those companies. Following the Edward Snowden leaks, several large US tech companies were dropped from this list, which lowered their sales in China.

The authors developed three case studies detailing how the smartphone, apparel, and aircraft industries could be affected if the supply chains shifted.

- Regarding **SMARTPHONES**, the authors found that the shift of production to the United States would be possible assuming the correct incentives were in place, although it would likely cause an increase in prices due to higher labor costs. However, there would be some efficiency gains as the majority of product design occurs in the United States.
- The **APPAREL INDUSTRY** would likely face significant challenges if it were to move production to the United States. This is mainly because labor costs would significantly increase in an industry with already thin margins. In addition, the United States does not have the capacity in the labor market to fill the needed positions with the current unemployment rate less than 5%.
- The **AIRCRAFT INDUSTRY** would also face significant challenges if supply chains were relocated. Moving aircraft production to China would be difficult due to the long-term production cycles. In addition, Chinese companies entering the industry would be at a disadvantage compared to market leaders Boeing and Airbus. These companies have established design and production processes in place that would be difficult for new companies to replicate given the complex nature of the industry.

These three case studies illustrate the difficulties of shifting supply chains in light of potential tariffs or border taxes.

THE COST OF LEAVING NAFTA

Oren Klachkin and Gregory Daco, Oxford Economics, US Research Briefing, January 15, 2018

The authors attempt to quantify the impact of a unilateral US exit from NAFTA starting in first quarter 2019. They find that the United States, Canada, and Mexico would experience an initial rise in financial stress and a sharp, short-term downturn in the real economy. Long term, the impact on the United States and Canada would dissipate, but Mexico would likely struggle to adjust to the new trade relationship.

In the event of a unilateral US exit from NAFTA, tariffs would revert back to the WTO's most-favored-nation rules. Based on these rules, the authors estimate that tariffs on US imports from Canada and Mexico would rise to roughly 3.5%, and tariffs on US exports to Canada and Mexico would rise to about 4.2% and 7.4%, respectively. The shock from higher tariffs would initially be felt in financial markets. Investors—fearing the ripple effects on US markets, the possibility of more protectionist policies, and less competitive US exports—would likely reduce their exposure to US equities in favor of safe-haven assets, such as US Treasuries. The authors estimate that S&P 500 prices would end 2019 below their firm's baseline forecasts by 5%, while ten-year US Treasuries would finish 2019 yielding 2.7%, or 4 percentage points lower than baseline forecasts.

More broadly, a unilateral US withdrawal from NAFTA would lead to a sharp, short-term downturn in the US economy in 2019. There would be a complex and drawn out adjustment process for businesses as they navigate the disruption to the integrated

North American supply chains, which will likely reduce business investment and employment growth. On the margin, US businesses would likely resort to relying more heavily on expensive domestic materials and workers, leading to a jump in inflation. Faced with slower employment growth and higher prices, consumers would likely reduce expenditures as real disposable income growth slows. The authors estimate that the decline in business investment and consumer spending would result in real GDP growth of 1.5% in 2019, as opposed to Oxford's baseline projection of 2.0%.

Still, the impact on the US economy would be short lived. The United States is a more insular economy, with total trade accounting for about 30% of GDP versus 80% and 60% for Mexico and Canada, respectively. This autonomy—along with US dollar appreciation, less hawkish monetary policy, and some US businesses relocating international operations to the United States to avoid tariffs—would help offset the initial impact over time. Industries that rely more heavily on North American supply chains would be hit harder and longer, but the authors estimate headline real GDP growth would likely revert back to Oxford's baseline estimate by 2022.

It is important to note that this is only one of many possible outcomes for NAFTA. This specific scenario would cause financial stress and detract from real economic growth in the near term, but the effects would largely dissipate over time. The Canadian economy would likely have an experience similar to the United States, but the trade-heavy Mexican economy would suffer a much more severe initial shock and a more lasting long-term effect. For all the potential financial distress and economic pain, a unilateral US exit from NAFTA would likely not do much to help reduce the US trade deficit, as any reduction in US imports would come with a reduction in US exports. ■

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