The Tariffying Prospect of a Trade War

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David Letterman, Oprah Winfrey, Phil Donahue, and Larry King – future President Donald Trump hit the talk show circuit extensively in the 1980's and 1990's. These interviews provide an insightful look into his core beliefs. Consistently, the most passionate commentary concerned foreign nations "taking advantage" of the U.S. – either by failing to contribute more to their own national defense or by running significant trade surpluses (U.S. trade deficits). In these interviews, the latter of which was usually directed (given the time period) at Japan. Today it is China.

Some argue that President Trump is actually in favor of free trade but wishes to renegotiate various trade treaties. That is, by embracing protectionist policies, free trade can be broadened on more "appropriate" terms. For example, some of the stated NAFTA renegotiation objectives include the elimination of "unfair subsidies, market-distorting practices by state-owned enterprises, and burdensome restrictions on intellectual property."[1] Perhaps this is indeed President Trump's ultimate goal, but this interpretation is contrary to significant evidence in addition to his own talk show confessions.

First, protectionism is theoretically consistent with President Trump's immigration position. If one believes immigrants take away American jobs, then logically one would also fear cheaper foreign goods which destroy the profitability of American companies – and by extension, cost U.S. workers their jobs.

Second, the protectionist measures enacted so far have been consistently indiscriminate in affecting both allies (e.g., Canada, Europe, etc.) and potential foes (e.g., China) – and thus almost all trade agreements – alike.

Third, President Trump, almost immediately upon taking office, pulled out of the Trans-Pacific Partnership. While one could easily argue this agreement actually hindered free trade given its excessively burdensome and complex rules and regulations, the rationale given for withdrawing was a protectionist argument: the preservation of American manufacturing.

Fourth, he has surrounded himself with advisors notorious for their protectionist policy advocacy. Most notable among them is economist Peter Navarro who authored the book Death by China.

If President Trump truly believes in protectionism, and if such advocacy largely helped him win the election, then we should expect this trade war to continue, broaden, and deepen. It likely would have begun last year but for the need to secure China's cooperation in dealing with North Korea. As evidence, note that the first major tariffs (March 1st) were issued just after U.S.-North Korean relations started thawing with Kim Yo Jong's (sister of Chairman Kim Jong Un and special emissary) overtures at the Winter Olympics (which ended on February 25th).

If the trade war escalates, can it *directly* cause a U.S economic recession? Many mainstream pundits, citing the infamous Smoot-Hawley Act of 1930, warn as such (which is odd, especially since the Great Depression was well underway before it was enacted let alone took effect).

It is rising interest rates which directly cause recessions as the origin of recessions lies in the preceding, artificial boom. When a central bank increases the supply of money, interest rates are artificially lowered. Since interest rates are a universal market signal to all businesses, investments which previously appeared unprofitable now make economic sense. However, the attractiveness of these projects is a mirage. These borrowed funds are actually being “malinvested” given the “true” level of interest rates absent the artificial stimulus. When interest rates eventually rise as monetary stimulus is lessened, the disruptive liquidation of the malinvestments in the ensuing downturn is known as a recession.

But tariffs may *indirectly* cause a recession. Currently, U.S. Treasury debt held by “Foreign and International Investors” is almost $6.3 trillion. China alone accounts for almost $1.2 trillion and may not be interested in more.[2] In May of this year, it was reported that China had halted its purchases of U.S. Treasuries.[3]

If foreign demand, led by China, for U.S. Treasuries cools (let alone if China liquidates its holdings); expect higher U.S. interest rates (all things being equal). If this, combined with the Federal Reserve’s planned liquidation of bond holdings in the face of increased U.S. budget deficits, develops, interest rates may rise significantly. A recession and financial market distress would surely follow. It is a tariffying prospect.

Endnotes:

1. “USTR Releases NAFTA Negotiating Objectives” Office of the United States Trade Representative. July 2017.
2. “Federal Debt Held by Foreign and International Investors. Federal Reserve Bank of St. Louis. https://fred.stlouisfed.org
3. “We Understand the Chinese Government has Halted Purchases of U.S. Treasuries” ZeroHedge. 4 April 2018.