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## Tariffs and Trade Skirmishes



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Many complain that economists never agree on anything. Sometimes, they do not even agree with themselves and provide contradictory advice. Famously, President Truman said that he would rather employ an economist with one hand than one with two who says: “on the one hand..., on the other hand ...”. This is true to a large extent, but the majority of the dismal profession agrees that free trade is good, while protectionism is bad.

This view is based on David Ricardo’s seminal theory of comparative advantage. Ricardo demonstrated that since no country is equally efficient in the production of all goods, industry specialisation combined with international free trade produces positive results for all and leads to stronger global growth. This was the theoretical basis for the repeal in 1846 of the infamous UK Corn Laws. A period of rapid industrial development, increased consumer demand (fuelled by lower food prices) and prosperity ensued.

If the rejection of the Corn Laws in the UK is a prime example of the advantages of free trade, the opposite is the Smoot Hawley Tariff Act adopted in the US in 1930, despite criticism from most prominent American economists. As the US introduced protectionist measures, the rest of the world retaliated with catastrophic results, aggravating the Great Depression and contributing to the rise of extremism in Europe. Not surprisingly, the spectre of Smoot-Hawley is often invoked when discussing the detrimental impact of protectionism.

Tariffs are bad because they distort demand and prevent mutually beneficial specialisation. They represent a tax on the consumer and dampen growth. This tax is profoundly undemocratic when introduced by executive order, as is often the case, rather than being voted by the legislators. Tariffs also open the door to crony capitalism and corruption. Inevitably, by imposing tariffs on selected goods, the government picks winners and losers. Tariffs are usually accompanied by subsidies granted to those presumably hurt by retaliation, which often turn out to be the supporters of the government in power.

**Access. Engagement. Resolution.**

A drive towards free trade has been one of the main components of the post-war economic architecture. Under the General Agreement on Tariffs and Trade (GATT) and World Trade Organisation (WTO), tariffs have been drastically reduced. While in 1947 average tariffs were around 22% for the developed countries, they stand now at 2% for non-agricultural products. Importantly, all WTO members accept the most favoured nation (MFN) rule, which says that any favour extended to one nation has to be extended to all members. This prevents discrimination.

Free trade in the post-war period has contributed to faster global economic growth. As a result, many millions have been lifted out poverty, especially in the emerging economies. This does not mean, however, that everything is perfect in the most perfect of all possible worlds. Although tariff barriers have become less relevant, some non-tariff barriers have remained in place. They are most prominent in the service industries and they take the form of myriad of regulations and controls. Also, for various reasons and excuses, agriculture escapes the rigours of free trade. The most egregious example is the EU's agricultural policy. Reminiscent of the British Corn Laws, it maintains artificially high food prices and reduces consumer choice.

WTO rules are not always easy to enforce and predatory trading practices still persist. The main culprit is probably China. The Chinese engage in the widespread theft of intellectual property. They have also erected trade barriers and are extending state subsidies to exporters. China also engages occasionally in currency manipulation to maintain competitiveness.

Nevertheless, even the much-lamented avalanche of Chinese goods has resulted in low prices for consumers and has helped control inflation. Benefits, however, have not been evenly distributed and there have been winners and losers. Unfortunately, the losers have been mostly members of the working class who have experienced stagnating real wages and have seen many well-paying jobs disappear. This has created a large constituency favourable to protectionism and against free trade. As we well know, they helped Donald Trump become President in 2016.

As promised in his campaign, the President opened trade hostilities on three fronts, against Mexico and Canada, against the EU and against China. But, what is Mr Trump trying to achieve? If the reduction of the enormous US trade and current-account deficits is his objective, chances of success are nil. These deficits reflect simply the fact that the US, having a low savings ratio, is an importer of capital from the rest of the world. Tariffs may reduce the deficit with one particular country, but have no impact on the aggregate deficit so long as the domestic savings ratio remains same and the dollar continues to be the main reserve currency.

A more benign interpretation is to look at the current tariffs and trade skirmishes as short-term temporary measures intended to reduce protection and eliminate predatory trading practices. If this is indeed the case, the end result may be more free trade not less. So far, there is reason for concern, but also for optimism. The negotiations regarding NAFTA have been successfully concluded. The results are modest, but positive. Canada has agreed to reduce protection of their dairy industry. The discussions with the EU are moving also in the

right direction, likely to result in reduced tariffs for American cars, and possibly reduced protection for the EU agriculture.

The thorniest issue is, of course, China. They have more staying power than US's North American neighbours and the EU. Not being a democracy, the government can inflict more pain on their citizens than the US can. China also owns over 1 trillion in US Treasury Bonds. By selling a part of the portfolio, they could create havoc in the US credit markets. They are unlikely to do it, however, since this action would diminish drastically the value of the rest of their holdings. Given the economy's heavy dependence on exports to the US, China is suffering more than the US as the hostilities continue. The Chinese stock market is sharply down, while the US market is strong. Prospects for growth in China have also deteriorated. Ironically, the fact Mr Trump is neither persistent nor consistent is good news in this context. The most likely outcome is modest, but constructive, concessions from China and Mr Trump declaring victory and moving on to the next subject.

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