No Mr. Trump, Tariffs and Trade Wars are not "Great:" The President's Policy will not work and is going to harm the American Economy in general & Central Valley Agriculture in particular

Daniel Garst

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Today's talk will cover the following three main points:

First, the US trade deficit is not caused by "bad" trade deals & "unfair" trading practices.

- Basic economics & empirical evidence points instead to the US ratio of savings to investment.
- The savings-investment balance, in turn, affects exchange rates & trade deficits and surpluses.
- Lastly, differentials in economic growth & interest rates spreads drives trade deficits.
- Thus, Trump's tariffs won't work & in fact will worsen the US trade deficit; it will soon be "dejavu all over again," aka a repeat of the 1980s.

Second, Trump is demonstrating here that he's not a master negotiator.

- With respect to the EU, Canada, & Mexico his demands for lower trade barriers make little sense.
- When it comes to being mercantilists in trade, China, the EU, & Canada are running rings around Trump
- Tariffs are not the way to deal with Chinese bad behavior on intellectual property & foreign firms in the PRC & POTUS is wrong to think the US can easily prevail in a Sino-American trade war.

Trump's tariffs will not only fail to work, they will cause major collateral damage to the US economy.

- Trump is clueless about global supply chains for manufacturing & how tariffs will disrupt such chains.
- US industries will suffer from foreign retaliation.
- American farmers in general will be taking it on the chin.
- Last but not certainly not least, valley growers & dairy farmers will be hard hit.

Why tariffs won't reduce the US trade deficit, aka Economics 101, I: The Balance of Payments (BOP)

Capital Account:

- Involves foreign investment flows into a country.
- These include foreign direct investment (FDI), real estate purchase, acquisition of corporate stocks and bonds, & buying of government debt.
- Such flows coming into a country is counted as a "plus," as foreigners are putting money into the economy receiving overseas investment.
- A country runs a capital account surplus when the value of foreign investment assets purchased by its citizens is exceeded by the value of domestic investment assets bought by foreign investors.

Current Account (CA):

- Trade balance, includes both the merchandise trade balance dealing with physical goods & trade in services; latter includes things like shipping, insurance, etc., & is always included in calculating the trade balance.
- Foreign income, such as interest payments & dividends on purchases of foreign stocks, government debt, inbound tourism, etc.
- Uncompensated transfers, largely foreign aid and remittances to family members of people living abroad.
- The CA balanced is largely determined by the trade balance.

As the term BOP implies, these two accounts must "balance:"

- The BOP basically follows the principles of double-entry bookkeeping, so the difference between the two accounts will = 0.
- Thus, if a country runs a $100 billion capital account surplus, it will run a $100 billion CA deficit; in other words the failure of exports to pay for imports is made up for by foreign investment flows.
- I'll be returning to this identity in the subsequent slides on what Economics 101 tells us about CA deficits & why tariffs won't solve the problem.

Why tariffs won't reduce the US trade deficit, aka Economics 101, II: Formal Analysis of Savings, Investment and CA Deficits

Ok folks, Identity Definition Time, yeh!!!

CA = EX – IM + R; EX = Exports, IM = Imports, R = non trade CA components (Bullets 2 & 3 of the previous slide's CA definition).

Gross Domestic Product (GDP) = C + I + G + (EX – IM); C is private consumption, I is investment, and G is government spending; we exclude R from GDP, as this is Gross **Domestic** Product and R represents overseas income; let's now define GDP as Y.

Notwithstanding the term "national," Gross National Product (GNP) is a broader measure of national wealth, including income from overseas, or R, along with what makes up GDP.
So GNP = Y + R, which can also be written as GNP = C + I + G + (EX – IM) + R.

We can subtract C + I + G from both sides of the identity to get GNP – (C + I + G) = CA, as CA = EX – IM + R.

Since savings are what is left over from private consumption and government spending, GNP – (C + G) yields S, or the level savings in the country's economy.

Substituting S for GNP gives us S – I = CA.

BOTTEM LINE: Countries where the savings-investment balance is negative will have CA deficits.

Why tariffs won't reduce the US trade deficit, aka Economics 101, III: Intuitive Analysis of Savings, Investment and CA Deficits, or Back to the BOP

First, think about savings in relation to investment & the BOP:

- In a closed economy, S = I, as the only funding source for investment are domestic savings.
- By contrast, countries integrated into the world economy can invest more than they save, how do they do that, you ask? By having a surplus in the capital account, i.e. getting large inflows of foreign investment.
- Now recall that the BOP must "balance," so a capital account surplus implies a CA deficit, so the CA in country where $S < I$ will be in the red, as opposed to being in the black (or in balance); this country will run a capital account surplus.
- But what about countries that save more than they invest? Since in these countries have a savings surplus, i.e. $S > I$, savers need to look overseas for investment opportunities, so they run capital account deficits and CA surpluses and capital account deficits, again the BOP must "balance."
- And yes, you've guessed it, that surplus savings goes to countries where $S < I$ to offset their CA deficits.

Second, think about savings, consumption and the CA balance.

- Countries with savings gluts are by definition consuming less & that lower consumption, in turn, implies lower demand for imports, improving the trade balance.
- By contrast, countries that don't save much are by definition consuming a lot & if the consumption levels are really high, some of that demand will have to met by foreign goods and services, sucking in imports and worsening the trade balance.

Why tariffs won't reduce the US trade deficit, aka Economics 101, IV: BOP balance, exchange rates & CA deficits and surpluses with an empirical illustration

Inflows of foreign investment to a country causes the exchange rate of its currency to appreciate.

- First, consider what happens when overseas investment flows into the US & foreigners seek to purchase American investment assets, they need dollars ($s) to buy them, the assets can't be bought with Euros or Yen.
- Countries running trade surpluses with the US can meet some of that demand with $s accumulated from trade—we buy foreign goods with $s, while foreigners pay for US imports with $s, so $s gained from exports > $s paid out for imports.
- Foreign countries often hold on to some of these dollars, but for countries with big savings gluts, $ holdings from trade won't suffice to purchase all the US investment assets desired by overseas investors.
- They will need to convert their euros, yen, etc. for $s, bidding up the demand for the greenback relative to these currencies, causing it to appreciate.
- The appreciating $, in turn, raises the price of US goods and services relative to those of their foreign competitors, adversely affecting the CA balance.

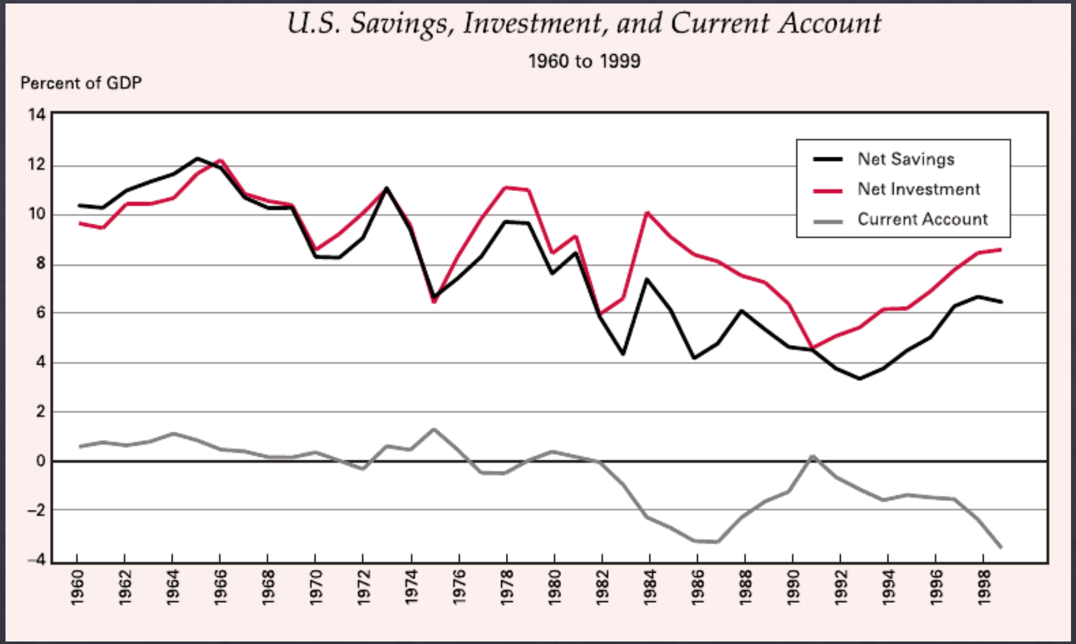
Empirical illustration, "Weltexportmeister" Germany in the early 1990s.

- In the early 1990s, Germany wasn't such a "Weltexportmeister," running a trade deficit. Why?
- Germany reunified in 1989 and had to invest billions of DMs to upgrade the economy of the former DDR.
- So the S/I balance in Germany tilted toward Investment and with domestic investment absorbing savings, German overseas investment flows decreased, leading to fewer DMs getting exchanged for $s and other foreign currencies.
- The DM appreciated and Germany's large trade surplus went into deficit for much of the 1990s.

Example of relationship between savings, investment and current account in the US

Empirical Evidence for the S – I = CA Identity

Striking confirmation below on S/I and CA relationship. Note when S is low to I, the US CA is in deficit.



Btw, the post-1998 data follow a similar pattern

The pattern holds across many countries across time

- From 1815-1914 Britain ran a CA surplus and invested massively overseas during this period, including in the US. Where, after all, did all that money to build American railroads come from?!!
- Today, high savings countries all run CA surpluses, with Japan, China, and post-1990s Germany being prominent examples.

Why tariffs won’t reduce the US trade deficit, aka Economics 101, V: Three other non-trade deal factors driving trade balances

Differences in economic growth rates:

- Economies experiencing relatively rapid economic growth tend to run CA deficits, as the higher growth their boosts consumption relative to slower growing trading partners, thereby sucking in imports & lowering export demand & negatively affecting the trade balance.
- Thus, economic downturns are a sure-fire way to eliminate a CA deficit, just as Mexico in the 1994-1995 “Tequila Sunrise” financial crisis!

Related to differing growth are interest rate spreads among countries:

- Relatively high interest rates in a country enable foreign investors to get higher rates of return than they would in their own economy; in particular, they borrow at low rates locally and invest in the foreign market where rates are higher for a better rate of return.
- As foreign investment flows into the host country with higher interest rates, its currency appreciates and CA balance deteriorates.

Lastly, the terms of trade

- “Terms of trade” refers to the prices of goods a country exports and imports (determined by many factors).
- In the early 19th Century, the terms of trade favored commodity producers because the industrial revolution drove down prices of manufactured goods relative to commodities.
- “Immiserating growth” anyone?

In light of what was just discussed, Trump's tariffs and trade wars will not reduce the US CA deficit

First, the US has a low level of savings relative to many of its major trading partners:

- Americans are not big private savers, according to 2016 OECD data factoring in PPP US households save 4.9% of income; in Germany, Netherlands, and Nordic Countries, the rates were at least 2x that; this gap is also wide when we're compared to Japan and China.
- Plus, as the chart on slide 7 shows, our budget began running chronic deficits in the 1980s (more on that later).
- So as we saw earlier, for the US, the left side of the S – I = CA accounting identity almost entire been in the red, leading to CA deficits.

Now what happens if this S/I balance is unchanged, remains negative?

- In this event, if Trump negotiates some great deal with Mr. Xi eliminating altogether the $350 billion trade deficit with China, we'd run bigger trade deficits &/or lower trade surpluses; again identity implies an **overall negative** CA.
- What about the impact of tariffs in general? They'll only reduce the export and import volumes, changing nothing with respect to the CA balance. Everyone loses, more on the collateral damage later, but will note here that we consumers will pay more for goods & the economy won't fully reap the specialization benefits of trade.

Bottom line: if you don't want a CA balance, then boost private savings &/or government spending. That presumes a CA deficit is necessarily a sign of economic weakness, and it isn't.

More cheery news: Hey, it's even worse than you might think now, Trump's policies will cause the CA deficit to go up!!

First, consider the S/I balance:

- The 2017 tax cuts are already causing the Federal budget deficit to rise & it will soon soar to over $1 trillion, or more than 4.2% of US GDP & stay there into the next decade; tariff revenue will not help cut the deficit, such revenues amount to $21 billion & Trump is giving farmers $12 billion to farmers hit by foreign trade retaliation.
- So the US balance of S to I is going to fall, leading to higher CA deficits.

Second, consider the differing rates of the US vs. most of its other trading partners:

- Thanks to the sugar high tax cut induced growth, the US economy will expand more rapidly than those in the EU and Japan; growth in the EU amounted to 2.5% in 2017, but with problems in Southern Europe, that growth is very likely to slow.
- So the US will be consuming more and that higher consumption implies rising imports—if growth slows in Europe and remains anemic in Japan, we'll be exporting less to them.

Third, consider interest rate spreads between the US vs. most of its other trading partners:

- The federal funds rate for interbank lending is now at 2.0% vs. 0.25% in the 2008 recession, the Fed is expected to raise that rate to 2.5% in 2018, 3.0% in 2019, and 3.5% in 2020; these increases might be greater if tariffs, as they typically do, boost inflation.
- By contrast, euro zone rates remains at about zero, and with growth slowing, Eurofed chair, Mario Draghi, aka "the Draght" will boost them gradually, while Japan's sluggish growth will keep rates low there.
- The ongoing spread in interest rates will suck in foreign investment to the US, causing investments to rise vis-à-vis savings, the $ to appreciate, and the US CA deficit to grow.

Thanks to Trump's macro-economic policies, it will soon be "dejavu" all over again, or back to the 1980s in terms of CA deficits

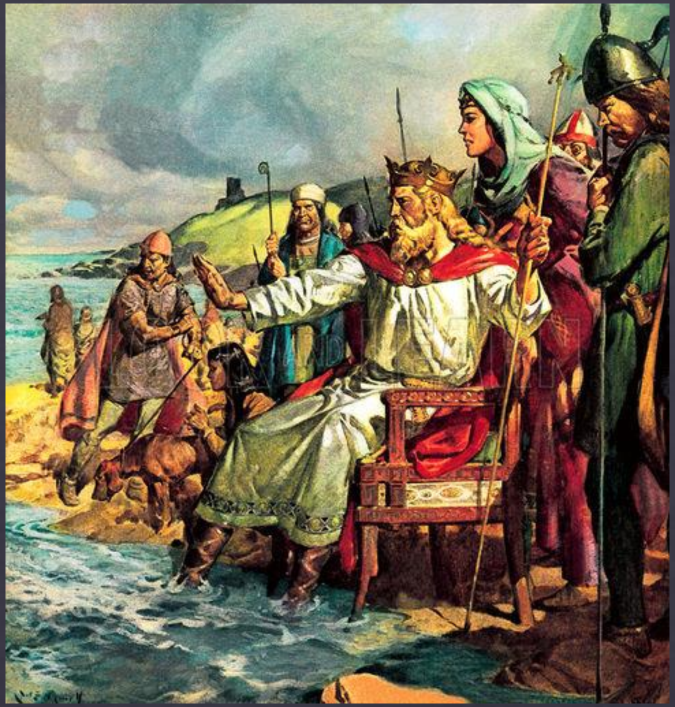
Macro-economic fundamentals in the 1980s:

- Recall the graph on slide 7, the US CA, which had been pretty well balanced up to then, went deep into the red.
- Americans were beginning to save less, but the biggest driver of the widening spread between S & I was government spending, driven by that good ol' supply side voodoo, causing Federal budget deficits to soar.
- Juiced up on tax cuts, the US economy grew faster than those in Europe (albeit not Japan), so the American demand for imported European products exceeded Europe's demand for our exports.
- Even more crucial, the expanding budget deficit and ongoing inflation led the Fed to keep interest relatively high, creating an interest spread between the US and Japan and Europe and causing foreign investment to flow into the US.
- That, in turn, led the $ to appreciate, devastating US manufacturers on the world market, marking the start of the "rust belt."

History repeats itself:

- Given what was just said on the previous slide, all of this should have an eerily familiar ring, or as Yogi Berra famously said, "It's dejavu all over again."
- Trump is set to replay the 1980s, which will undermine his effort to build up US manufacturing, a cornerstone of the "Make America Great" campaign, while throwing many of his blue-collar supporters, who will lose jobs, under a bus (will go back to that later on).

POTUS is illiterate when it comes to basic economics



Trump wants to cut our CA deficit while having high relatively high US economic growth & big tax cuts, with the latter boosting the budget deficit, thereby violating the laws of economic gravity; rings like the apocryphal story about King Canute & the tides.

Trump also mistakenly conflates CA surpluses with economic strength:

- In POTUS's extreme transactional and mercantilist view of world trade, CA surpluses denote that a country is "winning."
- This zero-sum mentality doesn't capture trade, which is a positive-sum interaction, where both parties gain.
- Plus CA surpluses don't necessarily denote economic strength; Russia is a case in point, it has a large CA surplus.

Hearing that stupid "piggy bank" line makes me not just want to scream, but go totally ballistic!

- Trump accuses countries having trade surpluses with the US as "stealing from our piggy bank."
- Excuse me, piggy banks are for savers, in the first quarter of 2018, the US net savings rate was 1.5% of national income, that's not much of "piggy bank."
- If anything, it's low-saving Americans & their profligate government who stealing from the piggy banks of higher saving Germans, Chinese, and Japanese.
- Their surplus savings, after all, are offsetting the US CA deficit, enabling us to consume more without lowering investment levels, while also helping the Federal Government to run larger deficits.

Trump is not just embracing a long discredited mercantilist trade framework, but is going about it ineptly to boot

First, most of Trump's demands on US trading partners make no sense:

- The Canadians, Mexicans & Europeans are bewildered by the demands for "fair trade," aka equal access to their markets, as the tariff and non-tariff barriers of these countries are similar to those of the US.
- Moreover, since the level of goods they'd export from the US is determined by market forces, in the absence of higher trade barriers, there's not much government can do to import more American goods.
- In the case of China, the Sino-US trade deficit is inflated by China's role as a place where goods get assembled and are then counted as Chinese products, even though the components come elsewhere and final assembly adds limited value to the product.

Second, the Chinese and Europeans are much shrewder about targeting goods for tariffs: Note the diagrams below (courtesy of Chad Brown & company via Paul Krugman):

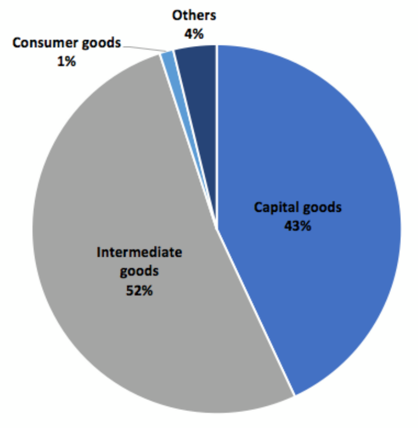
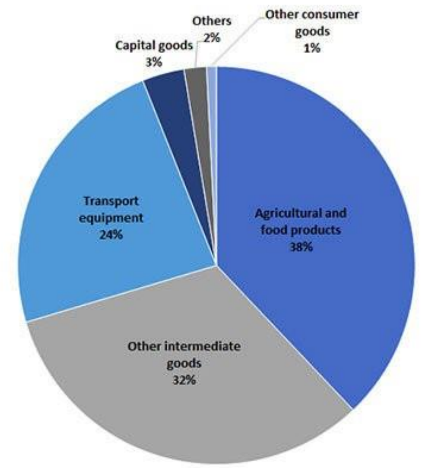


Figure 1a US imports from China subject to Section 301 tariffs, by producttype, 15 June lists
Source: USITC Dataweb.

Figure 1 US exports on China's June 15 tariff retaliation list, by type



More on Trump’s inept mercantilism

Tale of two tariffs, I: The Chinese Duties:

- Notice that just 1/3 are levied on capital & intermediate goods, this minimizes the impact on downstream industries using such imports as production inputs.
- 2/3 of the duties are on transportation, agriculture and food products, & other consumer goods driven by a well-thought out political strategy of hurting Trump voters, such soy farmers, Michigan auto workers, etc.
- Btw, before the looming US-EU trade war got temporarily put on hold, the EU did the same, targeting Wisconsin products (Harley Davidson motorbikes & cranberries) & Kentucky Bourbon; hum, who were they thinking about here?!!

Tale of two tariffs, II: The US Duties on Chinese Products:

- A whopping 95% are on capital & intermediate goods.
- This maximizes the negative impact on downstream finished goods manufacturers of the Sino-US trade war.
- At the same time, many of the capital goods industries, above all steel, are not labor intensive & employ relatively few workers, so protecting them yields limited benefits.
- Finally, to make another aside to Europe and Canada, invoking national security as a rationale for steel duties was a slap in the face of close US allies.

Better methods exist than tariffs for dealing with China:

- Target key Chinese state-owned enterprises, Trump passed up an opportunity to do that with ZTE, hint as to why, it’s POTUS family business interests.
- Form coalitions in E. Asia with states uneasy about rising Chinese influence, again another blown opportunity, as Trump rejected the TPP & wages trade wars; other states are now forming trade blocs excluding the US.

From Trump's inept mercantilism to the collateral damage it will inflict on our economy

Outcome of a Sino-US trade war?

- First trade wars aren't easy to win & everyone loses.
- Trump argues that China has more to lose as its exports to the US greatly exceed our exports to China, leaving it with fewer goods to slap on tariffs and other import restrictions.
- But trade is less crucial to China's economy than in the early 2000's, falling from 10 to 2% of GDP.
- Moreover, China can life miserable for key US firms like GM & Apple that have extensive operations in the People's Republic.
- Although the country is unlikely to dump its huge holdings of US treasuries, it may well limit future purchases of T-Bills and other US government debt, helping to drive up American interest rates.
- Last but certainly not least, while cracks are appearing in Xi's rule, China's government is much more insulated from political pressure; in addition to creating economic pain among Chinese, US tariffs may also help the regime tap into the intense nationalism among the Chinese people.
- So my bet is on the US crying "uncle" first.

Collateral Economic Damage, I: Disrupted Manufacturing Supply Chains:

- Back in the 1960s, trade in manufacturing overwhelmingly consisted of "final" products like cars.
- Now intermediate goods, like car parts, account for a large share of trade in manufacturing, as firms rely on globalized supply chains; thus, even vehicles like Ram pickup trucks have lots of foreign content.
- Since Trump has so far targeted intermediate goods, his trade war will disrupt these supply chains, driving up production costs for these firms, forcing them to lay off workers or relocate overseas.
- For example, Missouri-based Mid-Continental Nail, which boasts the biggest nail plant in the US, is laying off hundreds of workers & is on "the brink of extinction" thanks to the steel tariffs.

Other economic collateral damage from Trump's Tariffs and Trade Wars

Consumers pay a tax:

- As any economist would say, tariffs impose a tax on consumers, as domestic shielded from foreign competition can boost the prices they charge for their products.
- In the case of the Trump's trade policy, when he extends tariffs in the trade war to finished goods, we will pay more for things like Apple I-Phones, other consumer electronic goods, etc.
- The taxes on intermediate, capital goods, such as auto parts & steel will boost prices for automobiles by at least $800-900; ditto for other products using steel, refrigerators, washing machines, etc.

Foreign trade tit-for-tat retaliation against manufactured goods produced in the US:

- BMW is America's biggest exporter of luxury cars, which are produced at its Spartanburg, SC.
- They & other European firms making vehicles in the US, including VW and Volvo, are talking about curbing expansion plans or relocating production outside of America, threatening the loss of high-paying jobs.
- Passenger aircraft are also in China's cross-hairs, if Boeing can't sell in China, Airbus will.

Impact on US agriculture, I: Farmers outside of California:

- China imports $20 billion worth of US farm products, 60% of which are soybeans; after the Chinese Government imposed a 25% duty on American soybeans, their sales to the People's Republic dropped 20% from the last year, causing our growers to lose market share to their Brazilian competitors.
- US soybean futures fell from $9.50 to $8.50 a week after China announced its new duties; oh yes, Europe won't fill this gap in export demand.
- China is also targeting pork, imposing a 25% duty on US pork imports; they and Mexican duties on pork will be a double whammy for US hog farmers.

Economic collateral damage closer to home: Valley farmers and Trump's Tariffs

Valley nut growers and the China market:

- China took in 12% of CA's almond production, the top grossing crop for Fresno Co.
- China & Hong Kong took 55% of CA pistachio exports valued at $339 million; Chinese view them as "happy nuts." Can anyone guess why?
- Combined value of pistachio and almond exports to China was $500 million in 2016.
- China has slapped a 25% duty on these and other US tree nuts.
- Moreover, China can get pistachios from Iran and almonds from Australia, Spain and North Africa.

CA nut growers have much to lose from a US-EU trade war: EU countries took in $2.95 billion of CA tree nuts, including $1.6 billion of almonds, $420 million of walnuts, & $380 million of pistachios.

Going back to China, it's not just tree nut growers:

- Food safety concerns over Chinese milk after the melanin scandal with infant formula.
- This makes China a potentially large market for Central Valley Dairies.
- Trump's trade war has put this lucrative prospect on ice.

Now for some economic prognostications

Impact on economic growth:

- At the very least the tariffs will slow down growth, even the POTUS's Council of Economic Advisors says that.
- Slower growth will lower Federal Government tax revenues, further exploding the budget deficit.

Recession anyone? The trade war will be one more headwind making a downturn likely by 2020:

- The rising budget deficit is one of those other headwinds, it will "crowd out" domestic US savings available for business investment, while diverting foreign investment flows into US Treasuries rather than foreign direct investment.
- As noted earlier, the inflationary effects of tariffs boosts the incentive of the Fed to raise interest rates, and the Fed may overshoot its equilibrium long-term target, helping to tip the economy into recession.
- More troubling, unlike the 2008-9 downturn, when deflation was the problem, as Nouriel Roubini is arguing, stagflation is now the big future threat; Trump's trade war makes that threat more likely.
- Finally, the stimulus impact of the tax cuts will fade in the 2^{nd} half of 2019.

One nightmare scenario & two long-term headwinds:

- Nightmare scenario, as the budget deficit soars, Trump casually tweets the idea of renouncing US government debt obligations to foreign holders of American Treasuries; most likely to happen if Trump is re-elected in 2020.
- Long-term headwind I: Trump's restrictive immigration policies will deprive the US of labor it needs as the society ages, plus his clampdown on legal immigration threatens to exacerbate STEM personnel shortages.
- Long-term headwind II: With its climate change denial, the administration is hindering our ability to compete in the green economy of the future; China is really forging ahead here.

OK, given my audience, I would be remiss not to muse a bit on the political fallout of Trump's trade war

2018 Mid-term elections:

- Impact will likely be relatively small as the fallout from the Trump tariffs and trade war(s) is going to take time to be felt.
- Plus, many Trump voters who will hardest hit by these measures will give the Administration the benefit of the doubt for a while.
- Issues like heath care security & Trump Administration & Republican corruption are more potent cards to for the Democrats to play this year.

2020 Presidential election:

- By 2020, the adverse impact of the Trump tariffs will be fully felt, especially if the trade war with China escalates, we get into a trade war with the EU, & NAFTA collapses—oh yes, we're also already in a mini-trade war with Japan.
- Once the Trump supporters who are going to be disproportionately affected by POTUS's tariffs and trade war(s) realize he has thrown them under a bus, they'll turn against him; if they don't vote Democratic, they'll stay home.
- So 2020 could be shaping up to be a perfect storm for the GOP, depending on how things like the Russia investigation, other scandals, & the Democratic-Republican enthusiasm gap play out.

Thank you for attending this talk!!

For those of you who wish to contact me, my email address is daniel.garst59@gmail.com; my personal website is www.danielgarst.com; on the latter you'll find lots of examples of my writing and PPTs for other talks I've given in Fresno. Those talks and the writing is largely about China.

Last but certainly not least, I more than happy to send you this PPT if you'd like to have it.

Now for Questions!!!