Research Note: Trumping Global Trade January 5, 2017

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Trumping Global Trade:
Potential Impact of Acting on Protectionist Rhetoric

K.P. O'Reilly, PhD, JD
kpo@nwpcapital.com

414.755.0461, ext. 110
172 N. Broadway, Suite 300
Milwaukee, WI 53202

Summary:

- Protectionist action would cause near-term economic harm for the US and its more vulnerable trade partners like Mexico.
- Many US firms would face disruption of complex supply chains.
- Several US states would bear disproportionate negative shocks.
- US consumers would encounter price increases due to tariffs.
- Economic disruptions could necessitate increased government social spending.

NWP Takeaway:
Trade war scenario; Punitive tariffs against China (45%) and Mexico (35%)

The theme of trade protectionism is commonplace in US elections with candidates from across the political spectrum arguing for "fair" trade. Nevertheless, President-elect Donald Trump's protectionist rhetoric during the campaign stood out as markedly antagonistic. Most notable were Trump's threats to impose steep tariffs on imports from China (45%) and Mexico (35%) so to promote job growth domestically. While protectionist rhetoric may successfully mobilize voters, implementation of such policies is a trickier proposition. Disentangling oneself from global trade is easier said than done, as revealed by the ongoing Brexit drama. Promises of reducing trade deficits and returning jobs from abroad will inevitably cause near-term economic shocks through loss of trade-related jobs and higher costs for businesses and consumers.

Challenges of Unwinding and Terminating NAFTA

In the case of the North American Free Trade Agreement (NAFTA), we can see the difficulties in severing long-established trade relations. Assuming the political willingness to step away from international trade agreements and impose protectionist tariffs and trade barriers, the economic implications could be significant and sweeping. Terminating NAFTA would jeopardize trade relations with the first (Mexico) and second (Canada) largest export destinations, in dollar terms, for US goods. This trade is significant, valued at nearly $550 billion as of 2015, greater than the next ten export destination countries combined.[1] Various estimates suggest that between 5 and 6 million jobs, or nearly 1 of every 29 jobs in the US, depend on NAFTA.[2]

NWP Takeaway:
Estimated 5-6 million US jobs tied to NAFTA-based trade

Unwinding NAFTA would require numerous US companies to reconfigure sophisticated supply chains built-up over the past 22 years. To gain a sense of the scope of the cross-border supply nexus between US and Mexico, a recent study found that 40% of all imports from Mexico contain components originally produced in the US. As the study's authors note "This means that forty cents of every dollar spent on imports from Mexico comes back to the US, a quantity ten times greater that the four cents returning for each dollar paid on Chinese imports."[3] It would take years to rebuild these supply chains and could result in a permanent annual reduction in US national income of more than $100 billion, or 0.8 percent, should Trump pursue his trade policies aimed at Mexico and China.[4]

Assuming the US remains in the World Trade Organization (WTO) (Trump has threatened to pull out of this arrangement too) tariffs would revert to most favored nation (MFN) levels which average 7.5% for Mexico and 4.2% for Canada.[5] In a scenario of neither NAFTA nor WTO membership, US goods could face 12.4% Mexican tariffs and 9.7% Canadian tariffs, the pre-NAFTA average tariffs.[6] We find it exceedingly unlikely (although technically possible) that Trump would implement the punitive rates of 45% (against China) and 35% (against Mexico) as these would surpass even the infamous 1930 Hawley-Smoot tariff rates.

Table 1. Mexican and Canadian Avg. Tariff Rates (%)

	NAFTA	Pre-NAFTA	WTO/MFN
Canada	0*	9.7	4.2
Mexico	0*	12.4	7.5

*Phased out over 15 years, last tariffs removed in 2008.

Source: Northwest Passage Capital Advisors, WTO

NWP Takeaway:
US punitive trade actions ineffective historically

Historical evidence rejects the notion that targeted tariffs will protect, or promote, US industries from foreign competition. A recent study examining 30 randomly selected historical instances of US anti-dumping and countervailing duties actions found that, absent a globally inclusive tariff regime, trade flows simply diverts to other countries.[7] Imports of the targeted goods typically rose 25% on average the year after the duty was ordered as other exporting nations filled the void.[8]

Alternatively, Trump supporters contend that his anti-NAFTA and tariff talk is merely meant to stake out a hardline bargaining position. Rather than terminate the agreement his real goal is to renegotiate so to carve out provisions deemed harmful to the US interests. It is worth noting that Trump is not the first incoming president seeking to amend NAFTA. In 2008, then President-elect Obama also promised to renegotiate and fix the Treaty's perceived shortcomings.

NWP Takeaway:
US-Mexico. Renegotiation more likely outcomes than NAFTA termination

Renegotiating parts of NAFTA appears more plausible than a full-blown trade war scenario or imposition of sanctions by the Trump administration. Post-election, there has been a marked decline of mentions of NAFTA, tariffs against Mexico, immigration, or building a wall by President-elect Trump. Moreover, several of the potential candidates to be US ambassador to Mexico are major NAFTA proponents. One, Al Zapanta, claims that Trump will not "throw out" NAFTA but rather will seek to modify the Treaty.[9] Other recent actions by the incoming administration, including a private dinner with Mexican billionaire Carlos Slim, point to a trade détente as to US-Mexico relations.

Given Mexico's greater vulnerability to NAFTA termination, its government has indicated a readiness to renegotiate portions of the Treaty. Mexican officials, however, have stood fast in rejecting the idea of revisiting tariffs and export quotas.[10] A potential complicating factor is a defeat of the PRI-led government in the 2018 elections given its poor showing in recent municipal elections. With the level of the anti-Trump sentiment in Mexico, it should be expected that the current Nieto administration, or any future government, will take a hard line in any re-negotiations with the US.

Playing Hardball with China

The US-China trade relationship is attracting increasing attention by the incoming administration. While candidate Trump railed against illegal immigration and NAFTA, his key economic advisors see China as the greater trade threat. Professor Peter Navarro, one of the campaign's advisors, advocates a more aggressive policy stance, including using punitive tariffs, to reset US trade relations with China. Additionally, the administration's inclusion of former steel industry officials, with a history of China trade antagonism, also suggests a more aggressive attitude. Arguably, a cold trade war has been underway as over the past several months the US and China have initiated dueling WTO enforcement actions.

NWP Takeaway:
China in Trump's trade crosshairs; vulnerable, but able to retaliate

Like Mexico, China appears more vulnerable in a trade war given its dependence on the US export market. A trade interruption would put pressure on the Chinese government already adjusting to the reality of slower growth. Given the low level of US imports, China has fewer opportunities to retaliate. Nonetheless, likely targets include US agricultural goods, automobiles, commercial aircraft, and exports of rare earth minerals.

Trickle-Down Effect on US States and Consumers

In the case of a full-blown trade war with China and Mexico, the US could suffer significant near-term economic fallout. One study estimates, in a trade war scenario, that by 2019 California alone would lose 640,000 jobs or 4% of the state's private sector employment.[11] Several other states would suffer as well. The state of Ohio would lose 190,000 jobs while the state of Washington would lose 5% of private sector employment.[12]

NWP Takeaway:
The state of Texas has most to lose if NAFTA is terminated

Again, just as to NAFTA, its termination would have a severe ripple effect across several US states. Broken down to the state level, Mexico is the top export destination for five states, California, New Mexico, Arizona, New Hampshire and Texas, and the second most important for another seventeen US states.[13] The state of Texas, the largest beneficiary of NAFTA, would suffer significant economic shocks. It is by far the leading US state exporter to Mexico with total exports of $92.5bn in 2015, more than triple the next closest state, California, at $26.8bn.[14] It is estimated that nearly 382,000 jobs in Texas are dependent on NAFTA-based trade with Mexico.[15]

NWP Takeaway:
A trade war could cost US consumers $250bn annually

Should Trump pursue a more aggressive tariff policy, US consumers will face higher costs. Assuming normal consumption, and that higher tariffs are passed along to consumers, costs could rise to $250bn annually for American consumers without domestically produced equivalent goods.[16] Individuals living in California could face upward of $1,762.90 in additional costs per year due to the proposed tariffs.[17] These increased costs would be borne disproportionality by lower-income US households.[18] Trump's proposed punitive tariffs could result in a dead loss to the US economy of $459bn annually.[19]

Need for Increased Safety Net?

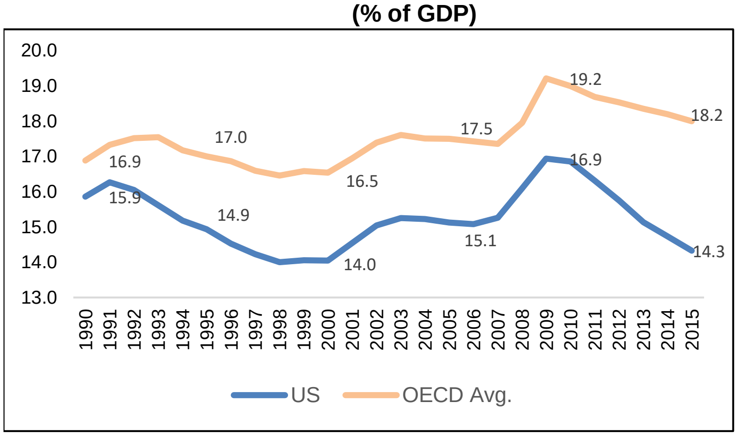
The IMF recently suggested that to mitigate economic disruption resulting from global trade governments should enact "sufficiently broad social safety nets, as well programs to support retraining, skill building, and occupational and geographic mobility."[20] Such action appears out-of-line with the philosophy of the incoming US Congress. Although, it is unclear where President Trump will stand given campaign promises to maintain and increase certain social programs as well as improve upon Obamacare.

Ideologically reluctant to increase social spending, congressional Republicans may also be equally troubled by the high costs of preserving, or returning, jobs to the US. The recent effort to save approximately 800 jobs at the Carrier plant in Indiana in exchange for $7 million dollars in government incentives is a steal compared to previous efforts. In 2009, President Obama implemented tariffs against Chinese-manufactured tires over trade dumping allegations. At the time, the action was justified in part to protect over one thousand jobs from what were deemed as illegal Chinese trade practices. A subsequent study shows that while perhaps 1,200 US jobs were temporarily saved, US consumers paid an additional $1.1 billion just in 2011 for more expensive, tariffed Chinese tires. In essence, US consumers paid $900,000 for each US job allegedly saved.[21] Far less could be spent on training and educating workers for current and future in-demand jobs rather than grasping to soon-to-be-defunct manufacturing jobs.

NWP Takeaway:
Republican Congress faces dilemma of more social spending versus costs of "protecting" jobs

Meanwhile, US government expenditures, as a percentage of GDP, have consistently run below the OECD average since the late 1970s. This gap widened in the 1990s, at a nearly 2% difference, and has steadily grown since 2010 to nearly a 4% as of 2015 (Figure 1). Much of this divergence is accounted for by differences in social welfare spending. As a recent study contends, "the disconnect between the United States' massive increase in trade exposure and minimal (if any) associated growth in the size of government is at the heart of the apparent turn toward protectionist politics this election year."[22] It should be expected that without domestic policies alleviating economic inequality caused by global competition, anti-trade populists will continue to draw support from US voters.

Figure 1. US v. OECD Avg. Government General Expenditures (% of GDP)



Source: Northwest Passage Capital Advisors, World Bank data

Conclusion

Based solely on the incoming President's tough talk on trade, we judge the proposals insinuated so far as negative for near and medium-term economic conditions in the US. However, we view the political willingness to go forward with the most extreme tariff scenarios with a high degree of skepticism. Such claims reflect campaign bravado rather than actual intent.

NWP Takeaway:
Expect moderation of anti-Mexico trade stance, but elevated tensions over Chinese trade

Trump's victory arguably provides a mandate, and certainly an expectation, to upset the status quo regarding US trade relations. Notably, although Mexico bore the brunt of pre-election trade talk, growing signals (tweets) suggest that US-Chinese trade will be subject to greater scrutiny. Consequently, we predict a shift away from a worst-case NAFTA termination scenario to a more likely renegotiation approach, but expect a ratcheting up of trade tensions with China.

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