Why Did Trump’s Trade War Fail? (Notes toward a proper paper)

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For the most part, Donald Trump’s economic policies have been straight Republican orthodoxy. Tax cuts; environmental deregulation; an unsuccessful attempt to repeal the Affordable Care Act. There has been little evidence of the economic populism he ran on in 2016.

The big exception has been trade policy. Not only has Trump been the most protectionist president since the 1930s, he has effectively ripped up the framework that has governed trade policy since FDR signed the Reciprocal Trade Agreements Act in 1934.

One reason Trump has been able to be heterodox on that front has been the peculiar institutional structure of trade policymaking. To oversimplify a bit, the RTAA established a system that took away the ability of Congress to insert special-interest provisions into tariff legislation. Instead, the executive branch negotiates trade agreements with other countries, and Congress simply votes these agreements up or down.

From the beginning, however, the framers of trade legislation realized that the system couldn’t be too rigid. In order to avoid political backlash that could destroy the system, there needed to be “pressure releases” — ways to offer some relief to industries facing sudden import surges, perceived unfair competition, and so on. So there are a number of circumstances under which tariffs can be temporarily imposed without a wholesale rewriting of legislation: disruptive competition from abroad, foreign subsidies, dumping, national security.

The decision on whether or when to impose these tariffs is left up to the executive branch. The idea — which worked until Trump — was that while Congress might be in the thrall of special interests, the president would have a broader view, taking diplomatic considerations and the state of the world trading system into account.

It turns out, however, that this system offers extraordinary freedom of action to a president who is less concerned than Congress with diplomatic and systemic issues. While there are quasi-judicial procedures for determining whether, for example, an import surge is disruptive (Section 201) or foreign countries are engaged in unfair trade practices (Section 301), a determined president can choose to impose tariffs on those grounds whenever he wants. And while the national security argument (Section 232) has historically been used very sparingly, if a president chooses to declare that, say, imports from Canada threaten national security, there are no legal ways to limit his actions.

As a result, Trump has been able to radically change US trade policy without any need for legislation. Figure 1 shows total US customs duties — a poor measure of the overall impact of protectionism, as we’ll see later, but still an indicator of the radical break in policy:
A better quantification comes from Chad Bown at the Peterson Institute, who has tracked tariffs imposed by the United States on China and vice versa, weighted by pre-war commodity shares:
So Trump has used his freedom of action to launch a significant trade war. We can speculate about his motives. But the interesting question from an economic point of view, I’d argue, is why the trade war appears to have failed.

I don’t mean that the burden of tariffs appears to have fallen on U.S. consumers rather than foreign exporters, which was widely predicted. Nor do I mean that the net effect of the trade war on U.S. real income was probably negative, which is also what almost all economists would have predicted.

What I mean instead is that the trade war doesn’t seem to have achieved Trump’s stated aims — aims that the rest of us may consider ill-advised, but which should nonetheless have been achievable. Protectionism, it turns out, didn’t reduce the trade deficit, either overall or in manufacturing. It also doesn’t seem to have reversed the ongoing decline in manufacturing as a share of total employment.

Here’s the trade deficit in manufacturing:
And here’s the share of manufacturing in total employment:
How can we explain this lack of any visible effect from a fairly radical break in policy? In my discussions with economists, I generally hear three stories:

1. General equilibrium: Trade balances are determined by the savings-investment balance, so trade policy shouldn’t have an effect.

2. Cross-cutting policies: The 2017 Tax Cut and Jobs Act was supposed to bring about large inflows of capital — which, by a simple accounting identity, should have increased the trade deficit (although it’s unclear whether the Trump team understood that).

3. The structure of the Trump tariffs was poorly designed, even from his own point of view.

In what follows, I’ll make the tentative case for (3).

\[ S-I = X-M \]

One of the insights drilled into every student of international finance is that the current account balance is a macroeconomic phenomenon; trade deficits aren’t caused by asymmetries in protectionism or export subsidies, they are the result of saving-investment imbalances. Many, many economists have mocked Trump for citing U.S. trade deficits as evidence that foreign countries are taking advantage of us.
This is an important insight, but one needs to be careful about its implications. No, asymmetric trade policy doesn’t explain persistent U.S. trade deficits. But that doesn’t mean that a trade war can’t reduce the U.S. deficit in manufactured goods and expand manufacturing employment.

There are two key reasons trade policy could, in principle, have affected manufacturing trade and employment.

First, while it’s common in textbooks (including mine!) to make the simplifying assumption that savings-investment imbalances are exogenous to trade barriers — that we should write S-I = X-M, treating the equals sign as a causal relationship — that isn’t really right. As Obstfeld and Rogoff (2000) argued, barriers to trade in goods and services also have the effect of limiting international capital mobility.

One way to see this is via a reductio ad absurdum. Suppose that we were to discover that all the data from space probes is wrong, and that there is actually a flourishing economy on Mars with a well-developed capital market — and that the rate of return on Mars is substantially higher than it is on Earth. Would this lead to large-scale capital flows from Earth to Mars?

No, it wouldn’t, unless there is a radical reduction in space transport costs. After all, the necessary counterpart of large capital flows to Mars would be a large Martian trade deficit. And how could we manage that, when the cost of shipping goods to Mars is prohibitive given current space technology?

And Earth investors would face the same problem realizing future returns from their interplanetary investments. How could Mars repay, sending goods back to us, when it’s basically impossible to ship more than a few kilograms of stuff?

OK, international capital movements don’t face difficulties on that scale. But barriers to trade, both natural and artificial, drive a wedge between the real return available to a country’s residents and the real return available to residents of another country that might want to invest there. A rise in trade costs would widen that wedge, reducing capital mobility. And since the United States is a persistent capital importer, rising protectionism should, other things equal, reduce those capital imports and hence reduce the trade deficit.

So it’s a mistake to extrapolate from the proposition that trade deficits are a macroeconomic phenomenon to the conclusion that trade policy can’t affect deficits.

And there’s a further point. Many of us, myself included, tend to talk about manufacturing trade as if it were all trade. In many cases that’s acceptable shorthand: manufactures are a large part of trade, and fluctuations in the U.S. trade balance have usually been dominated by shifts in the manufacturing balance.
However, manufactures aren’t as dominant in U.S. exports as one might think, because we also export large quantities of services and agricultural goods, and with the rise of fracking we’re starting to see some significant energy exports as well. At this point manufactures only account for about 55 percent of U.S. exports of goods and services:

Figure 5

What this means is that Trumpian trade policy could, in principle, have functioned as a 21st century, advanced-country version of import-substituting industrialization. It’s now almost universally accepted that ISI was a bad development strategy. It did, however, definitely expand manufacturing in many of the countries that adopted it.

In summary, then, macroeconomic accounting identities can’t explain why Trump’s manufacturing protection failed to produce any visible expansion of manufacturing. We need to turn to other possible stories.

Did the TCJA undermine the trade war?

While many things have happened over the past four years, there have been three major Trump economic initiatives. Aside from the trade war, the others were the unsuccessful attempt to repeal the Affordable Care Act and the 2017 Tax Cut and Jobs Act.

The key aspect of the TCJA, from the point of view of this discussion, is that its central plank was a large reduction in corporate taxes. Proponents of the bill argued that this would lead to a surge in economic growth. Why?
Well, the answer crucially involved international capital flows. A reduced corporate tax rate was supposed to reduce the cost of capital, leading to a rise in the U.S. capital stock, which would translate into higher GDP and wages. Estimates from conservative think tanks like the Tax Foundation and from administration economists suggested that the U.S. capital stock might rise by 30 percent over the course of a decade.

What wasn’t much emphasized in these optimistic projections was that the projected rise in the capital stock was supposed to come via capital inflows; to achieve the numbers being suggested, these inflows would have had to be around 3 percent of GDP annually. And here the accounting identity matters: increased capital inflows would necessarily have had as their counterpart a larger trade deficit, and this expanded trade deficit would presumably have manifested largely in the form of a larger deficit in manufactured goods.

In short, whether he knew it or not — probably not — Trump’s trade policy and his tax policy were actually working at cross-purposes, at least as far as the manufacturing trade balance was concerned. Does this explain why protectionism didn’t deliver the intended results?

The answer is, probably not — because the tax cut didn’t work as advertised. Neither the expected surge in business investment nor the expected inflow of foreign capital materialized.

Actually, a caveat on capital inflows. Following the enactment of the TCJA there was a brief rise in measured net inward direct investment. But this appears to have been a statistical illusion, driven by one-time changes in tax avoidance strategies, as shown in Figure 6:
As you can see, there was a brief plunge in one form of measured capital outflow: reinvested earnings by foreign subsidiaries of U.S. corporations. This was almost exactly matched by a brief surge in U.S. dividends earned abroad. What was that about?

The answer is that many multinationals use internal pricing — transfer pricing on intermediate inputs, rental rates on intellectual property — to shift their measured profits around, causing them to manifest in low-tax jurisdictions like Ireland. As a result, a large fraction of measured direct investment — the IMF estimates 40 percent — is actually fictitious.

One result is that small changes in tax strategies can lead to large apparent changes in where earnings, and hence value added, are reported. This was the story behind “leprechaun economics”, the obviously implausible 34 percent growth rate reported by Ireland in 2015. Another result is that changes in tax incentives can cause large but essentially meaningless reported capital flows. What happened in Q1 2018 was that overseas subsidiaries of U.S. multinationals transferred ownership of some of their assets back to their parent companies, causing both a surge in dividends and large reported disinvestment. All of this corresponded to nothing real.

Why wasn’t there a genuine surge of corporate investment? One answer is that business investment, which mainly goes to short-lived assets like equipment and software, isn’t that sensitive to the cost of capital in any case. Another contributing factor may have been the trade war, which created uncertainty. Businesses were reluctant to invest in projects dependent on access to foreign inputs, because those inputs would or might be subject to tariffs. But they
were also reluctant to invest in import-competing production, because the Trump tariffs might not last. In effect, the trade war may have created an option value in holding off on investment, partially undermining the tax cut.

But to return to the former point, did the tax cut undermine the trade war? If it had, you need to think about the mechanism. How, after all, would capital inflows hurt manufacturing? The transmission mechanism would have been a strong dollar, making manufacturing uncompetitive. But there was not, in fact, a large rise in the dollar:

Figure 7

The story so far: neither general considerations of accounting identities nor the cross-cutting aims of the two major Trump economic policies offers a very good explanation for the trade war’s lack of results. Which brings us to the third option: bad design.

How not to wage trade war

The decline of import-substituting industrialization as an economic policy has reduced interest in the details of protectionism — in particular, in the differing effects of tariffs on final versus intermediate goods. But there used to be an extensive literature on “effective protection,” on how the incentives to engage in different stages of the production process depended not only on the overall level of tariffs but on their structure.

One main insight of that literature was that developing country tariffs often provided much higher effective protection than the headline tariff rates might suggest. If you put a 20 percent
tariff on imported cars, but imported parts accounted for 80 percent of the cost, you were providing 100 percent effective protection to the activity of auto assembly.

Another, less emphasized insight was that tariffs on imported inputs provided negative effective protection to downstream activities.

And that’s what seems to have happened with the Trump trade war. Tariffs were largely focused on intermediate rather than final goods:

Figure 8

The net effect, then, may actually have been to discourage manufacturing!

And one final point: the trade war to date has been largely focused on China — which means, potentially, that rather than protecting U.S. manufacturing it may to a large extent have simply encouraged a shift to other overseas sources:
Overall, then, we have a remarkable story: the president was willing to shatter previous policy norms to pursue a protectionist agenda, but doesn’t seem to have succeeded in providing much actual protection to the sector he was trying to favor.

Why this failure? If I’m right, it wasn’t because the policy couldn’t have succeeded, at least in terms of Trump’s own goals. Whatever you think of those goals, the policy was simply too badly designed to achieve them.