Bradley, Foster & Sargent, Inc.
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President Trump and Trade: A Return to Protectionism

> If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage.
>
> Adam Smith, *The Wealth of Nations,* 1776

> No nation was ever ruined by trade, even seemingly the most disadvantageous.
>
> Benjamin Franklin, 1774

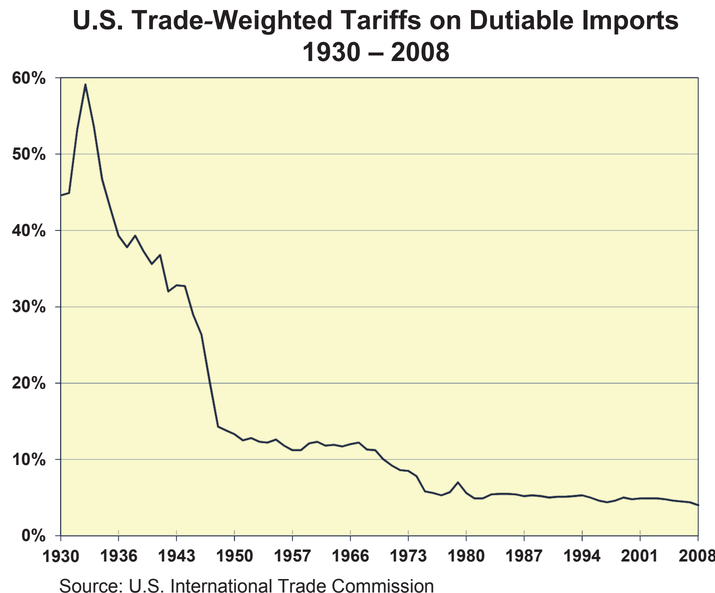
The year 2016 saw a sea change in politics, both here and abroad. First, the shock of Brexit passing in the U.K., then President Trump's victory. There were many reasons for Trump's upset triumph, but surely one of them was his neo-mercantilist views on trade. Since the General Agreement on Tariffs and Trade treaty (GATT) was signed by 23 nations in 1947, it has been politically and economically axiomatic that nations benefit from tariff liberalization and free trade. But the 2016 presidential election called this orthodoxy into question. Major constituencies in both the Republican and Democratic parties have now come out against trade liberalization. Throughout his campaign, presidential candidate Trump repeatedly called for 45% tariffs against imports from China, America's largest trading partner, and 35% against imports from Mexico, America's third-largest trading partner. His position on trade was a major factor in his electoral victories in the key manufacturing states of Michigan and Pennsylvania, and these wins, in turn, handed him his narrow electoral victory over Hillary Clinton. This investment commentary explores U.S. policy on trade historically and then considers what this brave new world of Trumpian mercantilism might mean for the U.S.

U.S. Policy on Tariffs from 1789–1930

From the birth of the American republic until the end of World War II, American policymakers generally adopted a protectionist trade policy of high tariffs. Tariffs accomplished two main goals: first and foremost, in those blessed days before income tax, tariffs were practically the only source of revenues to the U.S. government, bringing in 90%-95% of revenue. This was the case until the 16th Amendment to the Constitution was ratified in 1913, establishing Congress's right to impose a federal income tax. Tariffs averaged around 20% on imports. Customs agents collected the tariff before the goods could be landed, and the Coast Guard prevented smuggling. The second reason for employing a trade policy with high tariffs was to protect nascent manufacturing industries as well as farmers from mature foreign competition.

Then in 1929, the stock market crash ushered in the Great Depression. Three of the main causes of the Great Depression were the Federal Reserve Bank's 33% contraction of the U.S. money supply, the substantial increase in income tax rates in the midst of a recession, and the Smoot-Hawley Tariff Act.

The Smoot-Hawley Act was passed by Congress in 1930, but more than one thousand economists signed a letter to President Hoover asking him to veto it. Hoover was against the bill but, influenced by Republican leaders and leading businessmen, finally signed it. The bill was an unmitigated disaster. It effectively raised tariffs to 60% on imported goods and, according to the U.S. International Trade Commission, two years after the Smoot-Hawley Act, the volume of both U.S. exports and imports had fallen by approximately 41%. This was self-inflicted pain for the American economy, and the Smoot-Hawley Act had other pernicious effects. It caused other nations to erect high tariff barriers as well. Countries around the globe enacted beggar-thy-neighbor policies and aggressively depreciated their currencies in order to create demand for their exports. Overall world trade dropped 64% between 1929 and 1934. The global economic and political pain caused by high tariff trade policies resulted in 23 nations signing the GATT treaty in 1947 — a diplomatic effort largely organized by the U.S., whose post-war leadership was unchallenged at that time. GATT remained in place until 1995 when the World Trade Organization (WTO) was created. The chart below shows U.S. tariffs on imported goods, starting shortly before the Smoot-Hawley Act was passed and, subsequently, the rapid decline in the level of tariffs following the creation of GATT:



A Primer on Trade

Let's review the classical economic theory about why trade enhances the general well-being of a nation. The quotation from Adam Smith's *The Wealth of Nations* at the start of this essay is the founding principle of trade. If one country has the ability to produce a greater quantity of a good, product, or service than another nation, using the same amount of resources, it is said to have an *absolute advantage* in economy theory. If American consumers can purchase T-shirts from China which cost 50% less than those of the same quality produced in America, it is better economically for American consumers to buy the Chinese product, all things being equal. If Chinese consumers can purchase Microsoft software of equal or better quality than Chinese software at 50% less cost than software produced in China, it makes more sense economically for Chinese consumers to buy the American product. British economist David Ricardo wrote in 1817, "All trade, whether foreign or domestic, is beneficial."

Ricardo also expounded the principle of *comparative advantage*. This is the principle that nations should generally specialize in producing those goods in which they have relative advantage, not necessarily an absolute advantage. This concept is more difficult to understand. An example dealing with individuals rather than nations might help explain it: The president of a company might type faster on the computer than her executive assistant as well as bring in more business. Thus she has an absolute advantage in both areas. However, it still makes sense for the assistant to take care of the administrative functions because the president has a comparative advantage at bringing in new clients (which is more valuable to the company), while the assistant has a comparative (although not absolute) advantage on the PC.

Mercantilism

Mercantilism is the economic theory and practice that trade generates wealth primarily from the accumulation of a balance of trade surplus (excess of a country's exports over its imports), which a government should encourage by means of protectionism. It was practiced by the U.K. and leading European powers from the 16th through the 18th century, and its primary political purpose was to augment a state's power at the expense of rival national powers. John Locke and Adam Smith were strong critics of mercantilism, and England in the 19th century adopted policies of laissez-faire economics and free trade. Following World War II, the benefits of free trade (and the absence of protectionist measures) was the global dominant theory and practice until the 1990s. For decades, free trade, demographics, and economic growth created a virtuous circle of rising global prosperity. Attacks on free trade surfaced with the North American Free Trade Agreement (NAFTA), the three-way trade agreement between Mexico, Canada, and the U.S. which went into effect in 1994. NAFTA, which was originally proposed by the Republicans in the George H. W. Bush administration, was supported and enacted in the Clinton Administration. The leadership of both parties were strongly in favor of it, the main dissenting voices being unions and environmental groups. Many can remember the TV debate between Vice President Al Gore and billionaire Ross Perot over NAFTA in November, 1993, in which Gore emerged as the winner. In the 1992 presidential election, populist Perot had received 17% of the popular vote, and his opposition to NAFTA reflected the views of many in the blue collar working class. Starting with NAFTA and later with the Chinese entrance into the WTO in 2001, there was growing criticism of the benefits of free trade. The attacks on free trade have had two main themes: The first is that free trade has resulted in the loss of millions of manufacturing jobs in the U.S. and the hollowing out of rustbelt communities which had previously been supported by a strong industrial base. The second theme was that Japan in the 1980s and later China have employed neo-mercantilist policies of manipulating their currency to benefit exports and hold down imports, creating impediments for foreign companies operating in their countries, and controlling capital. These policies have resulted in large balance of payment surpluses and the accumulation of substantial foreign exchange reserves in Japan and China. There is much truth to the claims of American companies that they have faced an unfair playing field when trying to do business in Japan and China due to their governments' neo-mercantilist policies.

U.S. Trade

When the Smoot-Hawley Act was passed, exports were only 4.8% of GDP; in 2015, U.S. exports represented 12.6% of GDP. According to the U.S. International Trade Commission, worldwide exports in the 1990s grew nearly 140% faster than global GDP. Improvements in transportation and

communications, in addition to lower trade barriers, contributed to the expansion of trade in goods (and increasingly in services) and facilitated the creation of widely dispersed production networks. Companies began to break apart their production processes and distribute them around the world; they also sourced and produced parts internationally according to where an item could be made at a better quality, at a lower cost, or both. As an example, almost 90% of U.S. computer equipment investment is sourced overseas. The table below displays the U.S.'s major trading partners:

U.S. Top Trading Partners in 2015
($ Billions)

	Exports	Imports	Total Trade	Surplus/Deficit
China	$116	$482	$598	-$366
Canada	280	295	575	-15
Mexico	236	295	531	-59
Japan	63	131	194	-68
Germany	50	124	174	-74
South Korea	43	72	115	-29
United Kingdom	56	58	114	-2
France	30	48	78	-18
Taiwan	26	41	67	-15
India	21	45	66	-24
Italy	16	44	60	-28
Brazil	32	27	59	5

Source: U.S. International Trade Commission Data

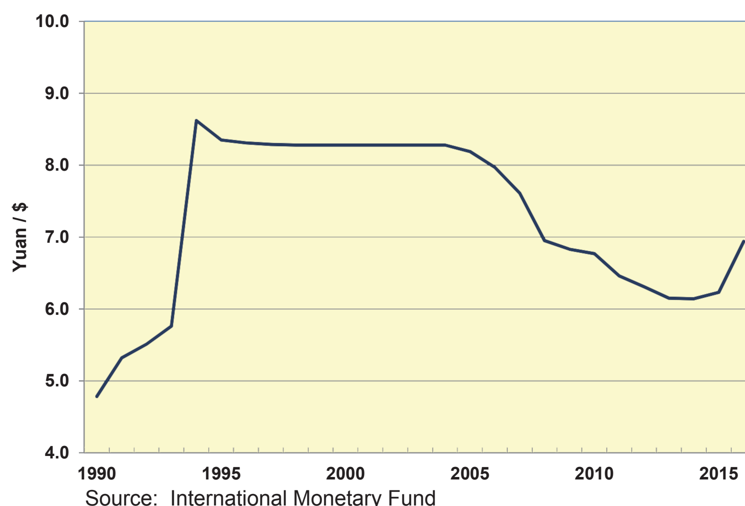
The Case against China

Deng Xaioping became China's pre-eminent leader in December, 1978, initiating a remarkable transformation of its economy. In 1990, total trade between the U.S. and China was only $20 billion; 26 years later, it has risen almost thirtyfold. Beginning in 1991, China's economy really took off, achieving average annual GDP growth of more than 10% for twenty years. In 1994, the Chinese engineered a huge devaluation of their currency with the yuan/$ exchange rate falling to 8.62 on average. In doing so, the Chinese government dramatically raised the cost of imports to Chinese consumers and industries and transformed China over the coming years into the industrial base for the world. Now China is the second largest economy in the world with a 2015 GDP of approximately $11 trillion compared with the U.S.'s GDP of $19 trillion. China's extraordinary growth resulted from its export-driven economy, which benefited from a low labor cost, a depreciated currency, a savings rate of almost 35%, a market-oriented economy, and the strong work ethic and ingenuity of the Chinese people. During this period, China grew its foreign exchange reserves from less than $100 billion in 2000 to $4 trillion in June 2014.

Many in the U.S. believe that China's success has come on the back of the American worker. On the one hand, cheap imports from China were a bonanza for American consumers. Clothes now cost the same as they did in 1986; furnishing a house is as cheap as it was 35 years ago. Two economists, Robert Lawrence and Lawrence Edwards, estimate that trade with China put $250 a year into the pocket of

every American by 2008. And these gains flowed disproportionately to the less well-off, who spend more of their income on goods than do the wealthy. On the other hand, America's balance of trade deficit with China ballooned from $10 billion in 1990 to a breathtaking $366 billion in 2015.

The populist case against China is that it robs Americans of their jobs. Cheap imports have been toxic for many American manufacturers — particularly in the Midwest and in the South. Some economists estimate that of the 5.5 million manufacturing jobs which disappeared in the U.S. between 1999 and 2011, approximately one million were lost to Chinese competition. Moreover, many American executives familiar with government and business practices in China state that the playing field is not level there. There is rampant intellectual property theft, and the Chinese government establishes regulations that force technology transfer from U.S. subsidiaries to Chinese partners. The government also finds ways to attack the strong market positions of some U.S. companies in China in order to enhance the market share of competing Chinese companies. Furthermore, there are restrictions in foreign equity ownership in some cases and policies that protect Chinese state-owned enterprises. President Trump's main response to this imbalance in the terms of trade between the U.S. and China (a trade deficit of $366 billion) has been to threaten to slap a 45% tariff against all Chinese imports and label China a currency manipulator. The chart below shows the dramatic devaluation of the yuan in 1994 and then later the gradual appreciation of the yuan from 2006 through 2015, which calls into question President Trump's charge of China being a currency manipulator.



The Case against Mexico

The case against Mexico appears less compelling. First of all, the Mexican economy with a GDP of approximately $1.2 trillion is less than 7% of the size of the U.S. economy. It is not a real threat to the U.S. economy. Secondly, the U.S.'s annual deficit in balance of payments with Mexico now approximates $60 billion – only 16% of the size of China's. Nevertheless, presidential candidate Trump called NAFTA the "worst trade deal ever" and vowed to renegotiate it. According to experts, the American auto industry has lost 350,000 jobs, or one-third of its work force, to Mexican workers earning less than 25% of the compensation of U.S. auto workers. However, some economists credit NAFTA

with saving the American auto industry, which still employs 800,000 workers. Gordon Hanson of the University of California, San Diego has written, “Without the ability to move lower-wage jobs to Mexico, we would have lost the whole industry.” Experts also say that NAFTA got a bum rap, because the surge of Mexican exports in the 1990s occurred largely because of the sharp devaluation of the Mexican peso resulting in cheap Mexican imports. While rustbelt workers are justified in their anger at NAFTA because of significant job losses, the integration of automobile production across countries with complementary work forces – cheaper labor in Mexico to perform basic tasks with more highly-paid and productive engineers and workers in the U.S. – played a key role in reviving the auto industry in North America. Experts write that carmakers and parts suppliers tend to cluster relatively close together so that assembly plants in Mexico help sustain a robust auto-parts industry across North America.

President Trump’s Game Plan on Trade

As we wrote at the beginning of this commentary, strongly populist feelings are now embedded in both political parties. President Obama’s administration helped craft the Trans-Pacific Partnership (TPP), and President Obama spent a lot of political capital in seeking to win its approval from Congress, but to no avail. Bernie Sanders railed against the TPP, and Hillary Clinton, representing the mainstream Democratic party view on trade, originally supported the TPP. Later in the campaign, under great pressure, she ended up opposing it. Protectionist sentiment, always rife among the unions and environmental groups – key stakeholders in the Democratic party – triumphed, and it is clear that the Democratic party can no longer be counted on to support liberalized trade and low tariff parries.

Two of President Trump’s major themes during the election were trade and immigration. In dealing with these issues, Trump made an anti-global pitch – an appeal to nationalism – in his slogan, “Make America Great Again.” Thus his appeal for many voters was perhaps more cultural than economic. He won the votes of many who place more value on being an American than a “citizen of the world.” That being said, the Trump campaign developed a seven point plan on trade[*] which is summarized below:

Trump’s 7 Point Plan to Rebuild the American Economy by Fighting for Free Trade

1. Withdraw from the Trans-Pacific Partnership, which has not been ratified.
2. Appoint tough and smart trade negotiators to fight on behalf of American workers.
3. Direct the Secretary of Commerce to identify every violation of trade agreements a foreign country is using and all agencies to take steps to end them.
4. Renegotiate NAFTA. If Mexico and Canada refuse to renegotiate, the U.S. will withdraw from NAFTA.
5. Instruct the Treasury Secretary to label China a currency manipulator.
6. Bring trade cases against China, both in the U.S. and at the WTO, as China’s unfair subsidy behavior is prohibited by terms of its entrance to the WTO.
7. Use every lawful presidential power to remedy trade disputes if China does not stop illegal activities, including theft of American trade secrets.

[*] www.donaldjtrump.com/policies/trade/

When examining Trump's plan on trade, it is not at all clear whether these ideas are deeply held principles, mere initial negotiating positions with other nations or international bodies, or just red meat for his populist constituencies. Trump appears, above all, to be a pragmatist so it seems likely that a number of these ideas may be seen both as appeals to his populist constituencies as well as starting points in negotiations. It is also important to note his seven point plan does not mention imposing a 45% tariff on all Chinese imports or a 35% tariff on all Mexican imports, which is encouraging because trade wars with these nations would be extremely harmful to the U.S. and to the global economy.

When trying to assess where all this will lead, we draw some tentative conclusions about Trump and his game plan in relation to trade. First, although his plan is labeled "Fighting for Free Trade," it is clear that Trump is a neo-mercantilist and the most protectionist U.S. president in many decades. Secondly, Trump appears to believe that the U.S. has been outwitted over the previous decades by crafty foreign negotiators who have taken advantage of the U.S. in terms of trade. He apparently makes this assessment based on two factors: U.S. jobs lost and America's large deficit in its balance of trade.

In regard to manufacturing jobs, it is highly unlikely that President Trump's policies will be able to reverse the downward trend in factory jobs. President Trump's jawboning (or some would say "bullying") of automobile companies and firms like United Technologies to keep manufacturing jobs in the U.S. rather than building more factories in Mexico will not erase the large difference in compensation between American factory workers ($75,000 or more) and less than $10,000 in many other countries. In 1989, factory jobs represented 17% of the U.S. workforce; currently they are just 9% of the workforce. These jobs are not coming back to the U.S.; rather, they will be replaced by jobs in services and technology — software engineering and coding, analytics, marketing, social media, alternative energy, cybersecurity and defense, and health care. We think that Trump understands this but will use his "bully pulpit" to accumulate political power in fighting for the American factory worker.

An even more important metric than the U.S. deficit in its balance of trade is the current account deficit. A country's current account includes funds flow from services, royalties and dividends, etc., which provides a fuller picture of a country's overall balance of payments. Furthermore, because of America's position as an economic superpower with approximately 24% of world GDP, and the U.S. dollar's role as a key reserve currency, the U.S.'s negative balance of payments results in other countries holding U.S. dollars as their foreign exchange reserves. Thus America's average current account deficit of approximately 2.5% of GDP is a positive thing for the global economy. Accordingly, if President Trump's administration focuses largely on reducing the deficit in its balance of trade, this could have negative effects on U.S. trade and on the economy.

Summary

As discussed above, a tough negotiating stance against China seems merited. Slapping a 45% across-the-board tariff on Chinese goods, however, would likely initiate a trade war between the two largest economies in the world and do great damage to both the U.S. and Chinese economies. We believe that President Trump understands this, and thus U.S. negotiations with China will be targeted at areas where there are clear indications that China is not abiding by the WTO rules, is abusing the intellectual

property rights of U.S. firms, or is using government pressure and regulations to force technology transfer. The idea of labeling China a currency manipulator is also a bad one, as it is no longer true. As the chart on page 5 above shows, there was a time between 1994 and 2004 when China dramatically reduced the value of the yuan and did in fact manipulate its currency. However, from 2008 to 2014, the Chinese yuan appreciated approximately 25% against the U.S. dollar. More recently, the Chinese yuan has depreciated around 10% as the Chinese economy has slowed, and the Chinese foreign exchange reserves have dropped $1 trillion to around $3 trillion. China has been defending the value of the yuan, not wanting to see its value drop any lower. This is not the sign of a currency manipulator, and it would be counterproductive to label China in this manner, but President Trump may play this card as a negotiating ploy. In regard to Mexico, withdrawing from NAFTA would be damaging to the U.S. economy, but the level of economic damage would depend on the resulting level of tariffs and trade arrangements. The Mexican and Canadian economies are integrated with the American economy, and it is difficult to foresee all the ramifications.

Over the past several years, perhaps the majority of Americans have turned against free trade. From recent polls, Republicans are more negative than Democrats, but in both parties, feelings about low tariffs and trade liberalization are not positive. These feelings are based more on cultural and nationalistic sentiments than on the empirical data. The empirical data over the past 70 years is that free trade has had a decidedly positive effect on the U.S. and global economy. The benefits are hard to perceive, as they are spread out across large constituencies of consumers, exporters and employees who do not realize how much their companies export. The pain is immediate and clear: shuttered factories and lost jobs. If President Trump is able to moderate his protectionist instincts and employ his pragmatic, negotiating skills to improve America's trading relationship with its key partners, so much the better. But implementing a strong neo-mercantilist trade approach runs the great danger of harming both the U.S. and the global economy, and investors will need to monitor carefully the Trump administration's actual policy steps in regard to trade in order to minimize potential sell-offs of the shares of individual companies or industries or the stock market itself.

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