Letter n°120

Why are higher tariffs a bad policy for the United States?

"Tariffs are a bad policy"
Mitch McConnell (former Republican Senate leader)**.**

Globalisation over the past 30 years, with its wave of factory closures in the West and relocations to the South, has affected the incomes of the middle class, the "Somewheres" dear to ***David Goodhart***. As a result, the resentment born from the consequences of this globalisation has been one of the driving forces behind the rise of populism and the election of Trump.

According to Trump, customs tariffs should help reduce the trade deficit, secure concessions, facilitate reindustrialisation, and enhance the competitiveness of American businesses.

To better illustrate the inefficacy of tariff policies, one can make two observations, highlight a futile objective, and identify two risks:

A first observation: the United States is less protected than other countries:

According to a recent report by the World Trade Organisation (WTO), the United States has lower average tariffs than its major trading partners: the average tariff is 5% on agricultural products and 3.1% on other goods, compared to respective rates of 10.8% and 4.1% in the EU; 17.1% and 8.1% in Vietnam; and 39% and 13.5% in India.

Thus, wielding the weapon of tariffs may be Trump's way of encouraging his trading partners to lower their own tariffs, a lesser evil. However, it is always difficult to decipher the messages of the American president.

A second observation: the enormous trade deficit in goods:

As a vast country, the United States is more open than ever before but remains relatively self-sufficient. In 1945, the ratio of external trade to GDP was just 5%; by the end of the Cold War, it had risen to 15%, and today it fluctuates between 23% and 25% of GDP. In China, this figure exceeds 35%, in France it has reached 70%, and in smaller countries like the Netherlands, it is 1.6 times their GDP.

- ***A deficit in goods, a surplus in services:***

In 2024, the US trade deficit increased by $133 billion to $918 billion, representing 3.1% of US GDP. December was the worst month, as businesses, fearing new tariffs potentially imposed by Trump, rushed to stock up.

This deficit is the result of a surplus in services, amounting to $300 billion, and a significant deficit in goods, nearly $1.22 trillion.

- ***A deficit with all major countries***:

The United States' top three trading partners in 2024 are Mexico, with just over $800 billion (exports plus imports), Canada, with slightly less than $800 billion, and China, with $575 billion. All other trading partners are significantly smaller, with Germany, Japan, and South Korea each around $220 billion.

Trump primarily aims to target countries running a trade surplus with the United States, including China ($296 billion), Mexico ($171 billion), Vietnam ($123 billion), Ireland ($85 billion), Germany ($85 billion), Taiwan ($74 billion), Japan ($68 billion), and South Korea ($66 billion). However, he does not intend to spare countries like Brazil, despite their trade deficit with the US.

Mexico, the top supplier, along with China and Canada, accounts for more than 40% of the $3.1 trillion in US imports.

- ***Deficits in almost all industrial sectors***:

In 2023, US imports primarily consisted of capital goods amounting to $860 billion, consumer goods at $760 billion, industrial equipment at $670 billion, automobiles and auto parts at $460 billion, and food products at $200 billion.

A futile objective: viewing tariffs as a means to rebalance trade and a substitute for income tax.

As ***Joseph Stiglitz*** notes in ***The Roaring Nineties,*** "if exports create jobs, imports must destroy them." "Importing goods from China – goods that require a lot of unskilled workers to produce – reduces the demand for unskilled workers in the US."

While temporary and targeted protections for two or three strategically important sectors may be justifiable, attempting to protect everything and striving for autarky makes no sense.

In the 1930s, during the last phase of protectionism under the Smoot-Hawley Tariffs, duties were high, but imports accounted for no more than 3% of GDP. Today, that figure stands at 11%, meaning financial markets will be far more sensitive to the risk of rising inflation and may demand higher risk premiums on interest rates.

- ***Measures on steel and aluminium***:

In a sector plagued by massive global overcapacity, Trump imposed tariffs of 25% on $88 billion worth of steel imports and $27 billion of aluminium imports. One-third of these imports originate from Mexico or Canada, 15% from Brazil, 14% from the EU, 10% from South Korea, and only 2% from China.

As a result of this announcement, US steel producers saw a sharp rise in their stock prices, as their capacity utilisation rates had fallen to 60%. However, industries that rely on steel or aluminium will suffer from reduced competitiveness.

Why seek to protect the steel industry and its 280,000 jobs when imposing tariffs weakens steel-consuming industries, which employ 12 million people? As ***Larry Summers*** noted in The Wall Street Journal on 31 January, for every steel and aluminium worker protected by tariffs, 36 jobs in steel- and aluminium-consuming industries are put at risk.

- ***Aligning with foreign tariffs***:

More broadly, Trump aims to impose reciprocal tariffs on trade with the entire world, a major shock for emerging economies like Brazil, India, and Thailand, which seek to protect their nascent industries through high tariffs. For instance, US plastics enter India with tariffs of up to 30%, while Indian plastics enter the US at just 6%. Imposing a 30% tariff on Indian products in the US market would cripple Indian manufacturers while also burdening American consumers with higher prices.

This approach also presents a challenge for European nations, as Trump intends to factor in VAT when calculating tariffs, despite the fact that VAT is borne by European businesses.

Such a policy is illogical, as it effectively allows foreign governments to dictate US tariff rates.

Moreover, what happens when the US does not sell an equivalent product to the country in question?

Finally, the administrative burden would be colossal. With 200 countries and approximately 13,000 products traded with each, applying reciprocal tariffs would require managing 2.6 million tariff lines!

First risk: more inflation, less purchasing power, and lower competitiveness.

- ***The McKinley precedent: Trump's reference***:

Trump frequently references President William McKinley (1897–1901) because McKinley annexed Hawaii, Puerto Rico, and Guam, just as Trump dreams of annexing Greenland and Canada, and he also promised prosperity through protectionism by raising tariffs then from 38% to 50%. Finally, as he wishes today, tariffs were then a substitute for income tax.

But public spending at the time did not exceed 5% of GDP, compared with 36% today, the Republicans lost the mid-term elections because the tariffs had increased the cost of living and McKinley ended up being assassinated.

- ***The impossible substitution of tariffs for income tax revenue***:

In 2024, the U.S. federal government collected $85 billion in tariff revenue, less than 3% of total federal revenue. Replacing income tax revenue with tariff revenue, as Trump envisions, is an illusion because income tax generated $2.2 trillion in 2023, while imports reached $3.1 trillion that same year. To achieve this substitution, tariff rates would need to be 70%, but such rates would weigh on purchases.

- ***A decline in purchasing power***:

If the substitution of imports with local production cannot be achieved, then the consumer will lose purchasing power because they will buy the same goods at a higher price.

In the optimistic scenario of reshoring, the consumer will probably still pay more because U.S. labour costs are higher than Mexican labour costs.

Trump acknowledges that tariffs will cause Americans "some pain", but he considers its implementation necessary to make America great again!!!

If tariffs result in a surge of inflation, leading to higher interest rates and an appreciation of the $, American exports will become more expensive, less competitive, and the trade deficit will worsen.

The American consumer will lose if purchases are unavoidable, and American producers will lose if they have to pay more for components bought abroad, should they be subject to retaliatory measures from countries targeted by the U.S. administration, or should the $ appreciates. The most affected sectors will be the automotive industry, agriculture, refining, and pharmaceuticals.

- ***The attractiveness of the United States***:

A key condition for the success of the tariff policy is reindustrialisation within the U.S. However, this effort is hindered by labour costs, a shortage of skilled workers, and deficiencies in infrastructure. Pursuing the illusion of reindustrialisation may be futile.

A wiser approach would be to promote America's comparative advantages in services, particularly in finance and digital sectors. In these areas, the U.S. continues to attract long-term capital investments amounting to 6% of GDP.

Why resort to tariffs? Thanks to Biden's plans, including the IRA and the semiconductor initiative, the U.S. has never seen such a high influx of foreign investments, 2,100 new projects between November 2023 and November 2024, mainly in semiconductors and industries requiring cheap energy. Simply continuing these policies would be sufficient. Meanwhile, China has never attracted so few foreign investments, only 400 in that period, compared to an average of 1,000 per year over the past decade, and investments in Europe have also declined.

- ***The negative impact on growth***:

According to ***BCG***, under the assumption of 60% tariffs on China, 25% on Canada and Mexico, and 20% on imports from the rest of the world, the increased cost of imports would amount to $640 billion. As a result, imports from China would rise from $427 billion to $628 billion.

The most significant shock would be on imported auto parts and vehicles, each increasing by $60 billion. Additionally, consumer electronics imports from China would see a price surge of $60 billion.

A second risk, US isolation:

- ***Countries will learn to do without the United States***:

By seeking to build a world of protectionist barriers, Trump is dismantling the multilateralism that benefits the United States and encouraging regional agreements elsewhere. China is promoting trade in Yuan, India has signed agreements with about twenty countries for trade in rupees, Saudi Arabia no longer exclusively uses the $ for its oil sales, and the EU is finalising the Mercosur deal.

- ***The elimination of international aid reduces American soft power***:

By wanting to eliminate USAID, which represents 0.15% of U.S. GDP or 0.7% of the federal budget, Trump is undermining multilateralism and reversing the beneficial contribution of the United States to global poverty eradication since 1945. The poorest emerging countries are thus economically and politically weakened, leading to increased conflict.

- ***The weakening of American SMEs***:

Small companies that import components from China are weakened by the tariff increases, as they often have no alternatives and lose competitiveness.

Conclusion: ***"Commercial trade wars are unprofitable" McKinley.***

Let's remember six key points:

- ***The proven inefficiency of tariffs***:

McKinley, Trump's model as a president, who was determined to impose high tariffs, ultimately recognised the flaws of this policy, as seen in the quote above. Instead of aiming for tariff reciprocity, Trump should pursue a reciprocity of 0% tariffs.

The first wave of tariffs initiated by Trump in 2018 left the trade deficit, as a percentage of GDP, unchanged at 2.2% two years later, proving ineffective. Inflation, at 2.1%, had barely increased between those dates, but the tariff hikes at the time were lower than those currently being considered.

- ***The risk on U.S. long-term rates:***

Notwithstanding the status of the $ and the liquidity of the U.S. market, U.S. long-term rates are already the highest in the G7. At what level would they be if the $ lost its status, if the Chinese or the Japanese, in retaliation, stopped buying U.S. debt? Answer: Americans have everything to gain by maintaining the approach that prevailed until Trump's election.

- ***The misunderstanding of job losses in the manufacturing industry:***

Job cuts in the industry, just like in agriculture in the past, are the result of productivity gains and the economy's shift toward services. Believing in reindustrialisation is futile. Despite the tariffs imposed by Trump during his first term and the reindustrialisation incentives implemented by Biden, the manufacturing sector's share of GDP has fallen from 11% in 2018 to 10% today.

Since 1975, the last year of the U.S. trade surplus, manufacturing employment has continuously declined, yet industrial production, according to ***Larry Summers***, has increased 2.5 times.

Rather than improving the competitiveness of American industrial companies, tariffs will weaken it.

- ***Does the United States have everything to lose from higher tariffs?***

America has much to lose from Trump’s foreign and trade policies.

By multiplying provocations and dramatic announcements, he damages American soft power. Consumed by hubris and convinced of the United States' unrivalled dominance in the world, he risks severe setbacks, discredits himself with allies, and plays into the hands of rivals like China and Russia. As a result, the country becomes isolated and weakens its global position.

Imagining, as Trump does, that higher tariffs will be borne by foreign exporters who will lower their prices and margins accordingly is an illusion, a sign of naivety.

- ***Tariffs create market distortions:***

The ***Peterson Institute*** has demonstrated the GDP gains generated by international trade liberalisation since 1950. For the U.S. economy, this gain is estimated at $2.6 trillion, or $19,500 per household.

Tariffs deprive consumers of the ability to purchase low-cost goods from abroad and prevent the full benefits of comparative advantage from being realised.

Tariffs do not necessarily benefit businesses. According to a 2021 study by ***Oxford Economics***, the tariffs imposed by Trump in 2018 resulted in a loss of 245,000 jobs in the United States.

In another area dear to Trump that is immigration policy, mass deportations make little sense, as they deprive key sectors such as agriculture, construction, and hospitality of low-cost labour.

Closing the door to immigration is equally illogical, as the U.S. birth rate of 1.7 children per woman is below the replacement level. Immigration, accounting for nearly 15% of the population, of which illegal immigration represents about a quarter, has historically been a source of wealth creation for the U.S., a country at full employment. Migrants are responsible for nearly a quarter of new business creations in the U.S.

- ***The avalanche of executive orders signed by Trump creates an atmosphere of uncertainty***:

Many industrial leaders, initially optimistic after Trump’s election, are now putting their investment plans on hold. Between the announced tariff measures and expected retaliations, they find themselves in a state of uncertainty.

Similarly, consumer confidence has recently declined.

In short, we should hope for the abandonment of this policy in favour of a more liberal approach.

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