How Trade Is at Risk: Think Trade War, for One

By Brian Horrigan, CFA, VP, Chief Economist

KEY TAKEAWAYS

- Further trade liberalization appears to be essentially dead for the next administration, whoever may win.
- The financial shock from a trade war, if it happened, would make Brexit look like a walk in the park…There may be survivors, but there would be no winners.
- Presidential power in the area of trade is unique in that he or she can act without congressional assent.
- The president has enormous powers to tear up trade agreements and, in many cases, to impose tariff penalties to advance US interests as interpreted by the president.
- Finding ways to make trade liberalization a win-win for everyone will be a job for responsible statesmen throughout the world.

As do many economists, I have a strong bias for free trade. These are not happy times for those of us with such a perspective. A largely bipartisan consensus on the benefits of free trade seems to have vanished, and trade policy is at risk in today's political arena.

There is a serious risk of unhappy times if a full-scale trade war breaks out, as I believe it could. The financial shock from a trade war, if it happened, would make Brexit look like a walk in the park.

Further trade liberalization appears to be essentially dead for the next administration, whoever may win. Hillary Clinton has disavowed the Trans-Pacific Partnership (TPP) trade deal that she helped negotiate and once praised, and she has repeatedly emphasized the need to step-up enforcement of existing trade laws. Maintaining the status quo, rather than further liberalizing trade, which the TPP would do, appears to be her approach, for now.

Donald Trump is also against the TPP, and other agreements as well. He is against the trade liberalization agreements that have characterized the last generation of politics and has pledged to undo those agreements. If he became president and implemented his proposed agenda, the US could end up in a trade war. It must be remembered that presidential power in the area of trade is unique in that he or she can act without congressional assent on many issues.

A President's Enormous Powers in the World of Trade

I don't worry much about domestic issues in the conflict between Trump and Clinton, the reason being that many important issues are decided by Congress and the courts. No president can spend money or change taxes without congressional authorization. Administration actions can come under court review, as is happening now with the Environmental Protection Agency climate plan. Under our system of federalism, many decisions are left to the states and local governments. And in any case, much of the economy is under private ownership; we don't depend on the White House for new apps for our smart phones, or new pharmaceuticals, or innovations in auto engine design.

International trade policy is an exception. Congress has granted over the decades under many different laws broad discretionary powers to the president on international trade matters. I think that is largely because foreign policy is considered under presidential control. Congress insists on having the say on granting trade liberalization but grants vast powers to the president for taking it away.

A DRAMATIC BREAK

Alas, a new bipartisan consensus on trade has emerged. Both parties are now against further trade liberalization, with some party representatives wanting to reverse recent liberalization.

The president has enormous powers to tear up trade agreements and, in many cases, to impose tariff penalties to advance US interests as interpreted by the president. While Clinton has restrained herself from making bold statements on the issue of trade, Trump has suggested a willingness to use such powers.

In his campaign speeches and platform, Trump has variously proclaimed that he would "rip up" certain existing trade agreements (the US has 20 bilateral free trade agreements), renegotiate the North American Free Trade Agreement (NAFTA), and impose a 35% tariff on imports from Mexico and a 45% tariff on imports from China. In addition, Trump has called the World Trade Organization (the WTO, which is the successor organization to the General Agreement on Tariffs and Trade, or GATT) a "disaster" and threatened to pull out of it. There are 163 members of the WTO, covering essentially all global trade, and trade agreements under GATT and WTO have reduced tariffs significantly throughout the world. The US is by far the largest member of the WTO; if the US were to pull out of the WTO, I don't know what would be left of that organization or any of its trade agreements. If the US were to leave the WTO, US tariffs on foreign goods and foreign tariffs on US goods would likely surge. Of course, we do not know if Trump would actually carry out any of these ideas if he were elected to office. The reader can decide if it is just campaign rhetoric or if it is a real policy proposal.

A Dramatic Break With the Bipartisan Past

From President Franklin Delano Roosevelt on, there has been a bipartisan consensus that broad-based trade liberalization is good for America and good for the world, and that trade liberalization has contributed toward a more peaceful world and has helped spread American values.

The Republican Party had been a party for tariffs from Lincoln through Hoover, but that attitude ended after the Second World War. Why?

First, President Hoover responded to the start of the Great Depression by signing into law one of the most severe protectionist bills ever written, the Smoot-Hawley tariff. The new tariffs didn't cause the economic downturn, but they made the downturn larger and deeper, especially after US trading partners retaliated by raising their tariffs. After the disaster of the Depression, politicians started to understand how destructive protectionism can be. Second, post World War II reconstruction required trade liberalization, which the US supported with the creation of GATT, the World Bank, and the International Monetary Fund (IMF). The two major parties were in substantial agreement about the virtues of trade liberalization, and the consensus continued until the mid-1980s.

Over the past three decades, the consensus has been unraveling. Ironically, the two parties flipped sides on the issue. In Congress, it has been primarily the Republicans who have carried trade liberalization through for the past three decades. In the White House, however, the bipartisan consensus has continued so far; every president has advanced some trade liberalization measures.

Alas, a new bipartisan consensus on trade has emerged. Both parties are now against further trade liberalization, with some party representatives wanting to reverse recent liberalization. Based on statements from the two candidates, a best case scenario going forward would put trade policy at a standstill. A worst case scenario would be a reversal of trade liberalization. In other words, it appears that the choice could be something between going nowhere or going backward.

The Big Risk Now Is Going Backward

Marcus Noland and Gary Hufbauer are trade experts at the Peterson Institute for International Economics (PIIE) and vigorous proponents of free trade. The authors addressed both candidates' professed plans and are displeased with their official pronouncements on trade.

To underline their deep concerns, they recently released a 49-page PIIE paper called "*Assessing Trade Agendas in the US Presidential Campaign.*" In the preface to their paper, PIIE president Adam Posen writes:

> ***"Make no mistake, the proposed trade policies of both Hillary Clinton and Donald J. Trump, the 2016 Democratic and Republican Party candidates for president, would deeply harm the American economy. Furthermore, they would primarily hurt average American households on modest incomes, and especially many of the individuals and communities that were already hard hit by the crisis. Curbing trade will worsen rather than solve the problem of American income stagnation by reducing families' purchasing power, and by further slowing productivity growth…Backing out of the Trans-Pacific Partnership (TPP) agreement with our allies, as both candidates currently promise to do, would weaken our alliances in Asia, and embolden our rivals, thus eroding American national security."***

Can a President "Rip Up" Existing Trade Agreements?

If he or she wanted to, could a president (any president) actually do the things Trump has proposed vis-a-vis international trade, such as "rip up" existing trade agreements? Yes, at least in the short term. The table below describes presidential powers on trade, from PIIE:

OCCUPY THE WHITE HOUSE

I think that CEOs of large US corporations would form their very own Occupy White House movements to save NAFTA and the WTO, but the president wouldn't have to agree.

SUMMARY OF STATUTES AVAILABLE FOR PRESIDENTIAL CONTROL OF FOREIGN COMMERCE

NAME OF STATUTE	AUTHORIZATION TRIGGER	PRESIDENTIAL POWERS
TRADE AGREEMENTS		
NAFTA Implementation Act of 1993	Proclamation of tariffs Maintain general level of reciprocal concessions with Mexico and Canada	Proclaim return of MFN tariffs on imports from Canada and Mexico Proclaim additional duties following consultations with Congress
LIMITED STATUTES		
Trade Expansion Act of 1962, Section 232(b)	Finding an adverse impact on national security from imports	Impose tariffs or quotas as needed to offset the adverse impact
Trade Act of 1974, Section 122	Large and serious US balance of payments deficit	Impose tariffs up to 15 percent, or quantitative restrictions, or both for up to 150 days against one or more countries with large balance of payments surpluses
Trade Act of 1974, Section 301	Foreign country denies the United States its FTA rights or carries out practices that are unjustifiable, unreasonable, or discriminatory	Retaliatory actions at presidential discretion, including tariffs and quotas
ALMOST UNLIMITED STATUES		
Trading with the enemy Act of 1917	During time of war	All forms of international commerce, plus the power to freeze and seize foreign-owned assets of all kinds
International Emergency Economic Powers Act of 1977	National Emergency	All forms of international commerce, plus the power to freeze foreign-owned assets of all kinds

FTA=free trade agreement; MFN=most favored nation; NAFTA=North American Free Trade Agreement

Source: Peterson Institute for International Economics (PIIE), "Assessing Trade Agendas in the US Presidential Campaign," September 2016.

I would add to that list that the US Treasury has the power to designate a country a "currency manipulator," and if it does, the president can unilaterally impose penalties on such countries.

In the longer term, there would certainly be court challenges to presidential action, but it could take years to litigate. Congress may push back, but any new congressional laws could be vetoed by the president. I think that CEOs of large US corporations would form their very own Occupy White House movements to save NAFTA and the WTO, but the president wouldn't have to agree. The president can do whatever he or she wants.

Other countries might not wait to see what would happen. There could be retaliation, as is allowable under WTO rules (not that WTO rules would matter if the US withdrew from the WTO). Different countries might, defensively, seek alternative trade arrangements. I could foresee a strongly emergent Russia in Europe and China in Asia.

Survivors, but No Winners

PIIE worked with a macroeconomic model developed by Moody's Analytics under Mark Zandi where they analyzed three possible trade war scenarios. To examine the most severe of the three, they fed a scenario of a trade war with China and Mexico, but not other countries, into the macro model. The scenario is based on both Trump's declared policies and an assumption that US trading partners would retaliate.[1] The model simulations indicate that the result would be collapsing international trade, rising import prices, widening credit spreads, a higher VIX, a stock market slump, and lower corporate investment. The impact would be spread over the entire country, but trade-dominated states would get hit hardest. Proportionately, Washington state would feel the most pain. GDP growth would slow, and a recession would start in 2019. GDP growth would be close to zero in both 2018 and 2019, and the unemployment rate would approach 9%. The recession would eventually end, of course, but the US would have a permanently lower level of economic output as a result of the trade war. The effects of the other scenarios would be substantially softer particularly if countered by other policy changes.

THE KEY POINT

Something bad would happen to the US economy in a full-scale trade war, even if we are unsure of just how serious it would be.

I work with macro models similar to Moody's. It is wise to think of these models not as giving precise answers but rather providing flavors of what could happen. Necessarily, such models cannot assess detailed business linkages. Many businesses, particularly in autos and electronics, have complicated international supply chains, and a trade war with China and Mexico could massively disrupt US production. The key point is that something bad would happen to the US economy in a full-scale trade war, even if we are unsure of just how serious it would be. I think Moody's may underestimate the risks because it is a model just of the US rather than an integrated global model. What if Europe, Japan and China all slide into recession together with the US? And what if Trump raised tariffs on many countries rather than just China and Mexico? The results could potentially be much worse than the Moody's analysis suggests. The 1930s give an example of just how bad things have gone when all countries fell into recession at the same time while conducting a trade war.

In normal times, global central bank easing would help to nullify the shock of a trade war, but the central banks in developed market economies are near to, or at, the lowest feasible policy rates. Where would further easing come from? As for fiscal policy, how much room do developed market economies have for additional fiscal stimulus insofar as most of them have large deficits and a rising public debt? I also want to note that commodity prices would likely slump further in a trade war scenario, which could take down both commodity exporters and the banks that lend to them.

The US is huge, and you might ask, who would win a trade war? Could the US come out on top because of its large size? That is like asking who would win an all-out nuclear war. There may be survivors, but there would be no winners.

[1] *The Moody's model contains more than 1,800 variables but does not incorporate the impact of policy changes in trade or other areas such as tax code and undocumented migrants.*

PIIE did not attempt to simulate the trade policies of Clinton; there is nothing to be simulated, in their view. Clinton has not called for reversing recent trade agreements; rather, she has indicated a lack of interest in negotiating further trade agreements. The loss is that the US economy would likely proceed as it has been going rather than embracing any benefits of further liberalization.

Why Did the Trade Controversy Arise?

Many of us were surprised by how the controversy over international trade appeared in this election season. The analysis by PIIE and Moody's Analytics suggests that a sharp move to protectionism could have harmful consequences for the US and global economies. So why would anyone support protectionist policies if trade liberalization can do so much good?

NOT EVERYONE IS A WINNER

While economists, myself included, believe with good reason that liberalized trade can benefit most countries and increases average incomes, that does not mean that everybody is a winner.

I think one reason is that while the recovery from the severe recession of 2007-2009 has been long, it has also been shallow. So far, it has been the weakest recovery on record, with slow gains in employment and sluggish gains in real wages and real household incomes. Frustration over the slow recovery leads voters to seek someone to blame. Foreign competition has been blamed.

While economists, myself included, believe with good reason that liberalized trade can benefit most countries and increases average incomes, that does not mean that everybody is a winner. Recent research has documented that liberalized trade creates winners and losers. The fact that there are more winners than losers might not give much comfort to the losers. The surge in imported manufactured goods in the past three decades has crushed some US manufacturing firms and the communities that depended on them. To be sure, import competition was not the only factor reducing jobs; superior technology was also a factor, allowing machines to displace workers. Employment in the apparel and textile industries has mostly disappeared, and there have been significant declines in employment in manufacturing of electronics, furniture, electrical equipment and metals. The sad plight of towns that saw their factories close has been the topic of some songs by Bruce Springsteen, Billy Joel and country-western musicians.

A BURNING ISSUE

Even in the best of times, trade liberalization has few friends in politics.

Even in the best of times, trade liberalization has few friends in politics. As we've said, it is always easy to blame foreigners when life is hard; foreigners don't vote. Trade has become a burning issue in the past three decades as the bipartisan consensus on trade broke down; prominent politicians have adopted anti-trade views.

Here are examples. Representative Richard Gephardt, who led the Democrats in the House of Representatives from 1989 to 2003, repeatedly opposed trade liberalization legislation. In the 1992 presidential election, independent Ross Perot made opposition to NAFTA the centerpiece of his campaign. In the Republican Party, Pat Buchanan made opposition to NAFTA and other agreements a major issue before and after he left the Republican Party. Ralph Nader voiced opposition to trade liberalization when he ran as a presidential candidate for the Green Party in 2000. Full-scale riots broke out in Seattle in 1999 during anti-trade protests at a WTO ministerial conference. In 2006, Representative Sherrod Brown, now a senator from Ohio, published a book called *"The Myth of Free Trade,"* arguing that trade liberalization has harmed the US and global economies. Senator Obama criticized NAFTA and said it needed renegotiation when he was running against Senator Clinton in the 2008 Democratic primaries.

In the 2016 Democratic primaries, Senator Bernie Sanders boasted that he has voted against every trade agreement to come before the Senate and would continue to do so. In the 2016 Republican primaries, Trump crushed his opponents, largely using the issues of international trade and immigration. And President Obama has had no success in getting support for the TPP, which he negotiated, while major candidates in both parties rejected the TPP. Finally, negotiations for a Transatlantic Trade and Investment Partnership (TTIP)—a proposed free trade agreement between the US and European Union—appear to have collapsed because of irreconcilable differences, with little chance of success for the time being.

Those who have benefited from liberalized trade because they are in a position to export goods and services or because they get to buy cheaper goods and services may have been complacent about the losses involved in trade. It should not have been a surprise that those who have been losing in the competition with imports have turned to politicians like Trump and Sanders who have condemned trade liberalization. Looking forward, further trade liberalization may not be feasible unless the winners from liberalized trade make an effort to help the losers adjust to reality. Otherwise, further trade liberalization may be vociferously opposed.

Where Now?

I do not wish to get involved in the minefield of partisan politics. But as chief economist for Loomis Sayles, I believe that it is appropriate for me to alert people to risks to the US and global economies that I see. These risks appear real and significant. The focus of this paper has been mainly on the issue of trade liberalization, but there is an abundance of other issues that also affect the economy; some where the two candidates differ enormously and others where they hold somewhat similar views.

The friends of trade liberalization will have a hard task ahead of them. No matter who wins this election, it seems unlikely that there will be any trade agreements in the next administration; the TPP and TTIP look dead. And there is a danger that a destructive trade war could break out. In my view, the US economy looks likely to have less success than it could have had if politicians were to advance a policy of trade liberalization.

And looking forward to future elections, Sanders and Trump and Clinton may be retired, but the trade issue will remain. Future politicians in both parties may decide that protectionism is a winning issue in their campaigns. The danger of a trade war could be with us for years to come. Finding ways to make trade liberalization a win-win for everyone will be a job for responsible statesmen throughout the world.

AUTHOR

BRIAN HORRIGAN, CFA
VP, Chief Economist

Disclosure

This paper is provided for informational purposes only and should not be construed as investment advice. Any opinions or forecasts contained herein reflect the subjective judgments and assumptions of the authors only and do not necessarily reflect the views of Loomis, Sayles & Company, L.P. Investment recommendations may be inconsistent with these opinions. There can be no assurance that developments will transpire as forecasted and actual results will be different. Data and analysis does not represent the actual or expected future performance of any investment product.
We believe the information, including that obtained from outside sources, to be correct, but we cannot guarantee its accuracy. The information is subject to change at any time without notice.

Commodity Trading Involves Substantial Risk of Loss.

MALR016076