Yosemite Capital Management

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COMMENTARY

"Free trade is not based on utility but on justice." — Edmund Burke

Tariffs and Trade Wars

One thing economists of all flavors almost universally agree on is that ***free and fair trade benefits everybody***. Any protectionism that interferes with free and fair trade, such as tariffs, quotas, government subsidies, sanctions, restrictions, licenses, technical barriers, bureaucratic procedures, violations of contracts, forced technology transfers, expropriation of intellectual property, etc., diminishes the quality of life in aggregate.

However, any action for or against free and fair trade will have winners and losers, and over the course of time people and systems adapt. (But you will only hear about the losers and those who can't or won't adapt.) Because the financial markets have various combinations of winners and losers, many of which are not readily apparent, it is probably fair to say that ***if trade barriers are incrementally increased then future growth would likely occur at a lower rate than would occur if trade barriers are incrementally decreased***. That is, the current trade issues per se do not automatically have to be the proximal cause of a stock market decline.

The term "trade war" gets bandied about without people really knowing what this means beyond some vague concept involving tariffs or quotas. The term "war" indicates a serious problem that we should try to avoid, and thus fears are heightened on the mere possibility of hostilities. But can anyone satisfactorily determine what a "trade war" is? Are there not differing degrees of trade issues, from frictions to disputes to skirmishes to wars, and if so what are their definitions? How does one know when a country enters a trade war? How does one know when a country exits a trade war? When did the

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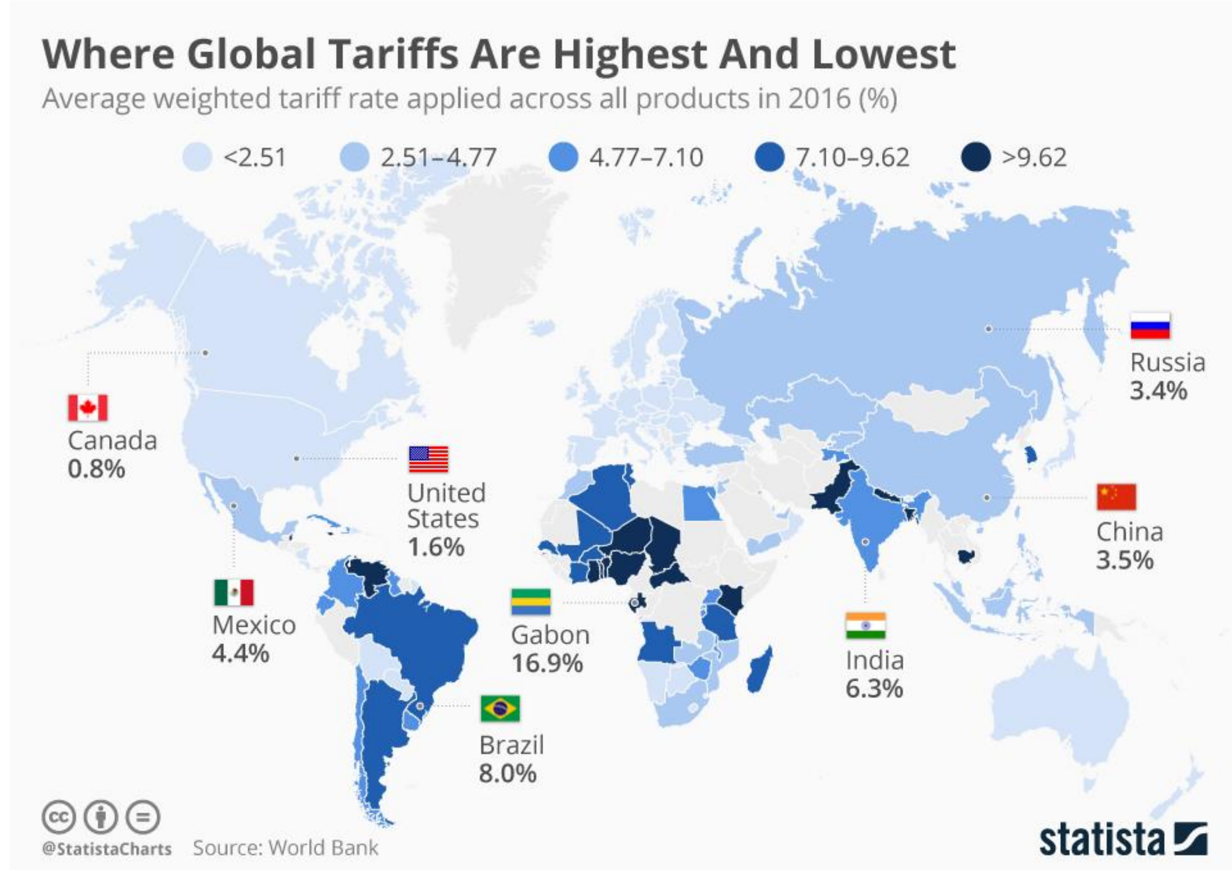
United States participate in previous trade wars, who were they against, and what were the consequences, especially to the financial markets? Is the USA headed for a trade war or are we already in one? How does one know if a country won or lost a trade war, or does everyone always lose? Is a trade war always bad, especially if the eventual result is a negotiated settlement that resolves unfair situations? How does one know the difference between initial steps done simply as negotiating tactics to achieve a grand deal versus a trade war? The absence of ready answers to these questions suggests far more emotion (especially political angst) than reasoned thought about the issue.

Given the emotion involved, which likely contorts any sort of trade issue into a full-blown "trade war", we would like to know some facts and ask others to do the same. Unfortunately this is not easily done because many trade barriers are not quantifiable. Even simple tariff numbers can be misleading because there are often many exceptions, both higher and lower, to a country's reported average rate.

Nevertheless, reports from both the World Bank and the World Trade Organization suggest that the United States generally has tariff rates that are less than half of the tariffs applied by China. (See Exhibit 1.) And while the average tariffs applied by the United States and the European Union are about the same, there are some major exceptions that stick out and cause friction between these two entities. (See Exhibit 2.) The United States has general differences with China and specific issues with the EU (and others) that are the crux of the current controversy. So why allow uneven and certainly unfair barriers to persist, especially noting their continued existence leads to sub-optimal growth?

Exhibit 1, Global Tariffs

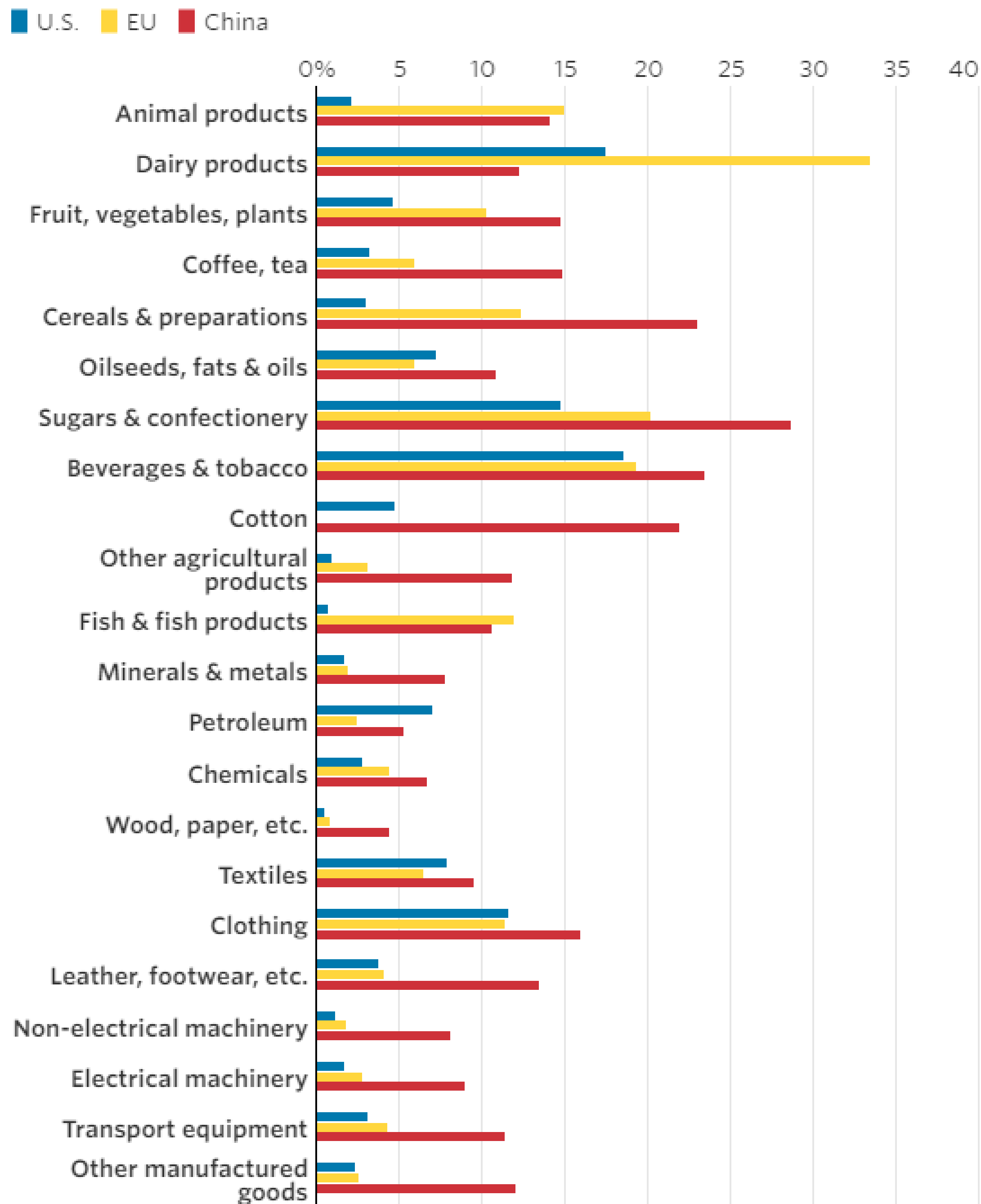
Average weighted tariff rates applied by China are significantly higher than those applied by the United States



Source: Statista.com

Exhibit 2, Average Applied Tariffs on Major Categories of Goods

China applies significantly higher tariffs on most major categories of goods than the European Union and the United States, while the EU charges higher tariffs than the US in many categories



Source: The Wall Street Journal

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Naturally, it is only fair that the United States would relax some of the specific tariffs it applies to certain imports from the EU (and others) as part of any grand bargain. Hopefully any new arrangements include reduced tariffs and other barriers to create freer and fairer trade to benefit all. Otherwise higher tariffs and other barriers would reduce freer and fairer trade to the detriment of all.

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Many are alarmed about the specific actions to impose tariffs on China, thinking that their tit-for-tat responses will result in an endless downward spiral and assure a trade war that has no winner. Once again, it is important to look at the facts before jumping to conclusions.

According to the US Census Bureau, in 2017 the United States imported about $505 billion of goods from China while China imported about $130 billion of goods from the United States. The disparity in these numbers, which has been the norm for years, clearly reveals that ***China is far more dependent on the United States than the other way around***. This is only natural given that the American consumer is perhaps the most desired customer in the world. China cannot simply replace one of its largest and wealthiest customers, certainly not in the near term and maybe not for a very long time.

China's economy is already facing trouble, as we wrote in our Fourth Quarter 2017 Commentary. Slowing growth for the foreseeable future was a given, and now that country faces potentially reduced demand for its goods and therefore even slower growth as a result of new tariffs imposed by the United States. This has already led the Chinese authorities to consider additional stimulus in an attempt to maintain the economic growth needed to assure continued improvements in the prosperity of its people. However, the stimulus will likely exacerbate its debt problem, perhaps the ultimate problem the country must eventually face and resolve.

For China to engage in retaliatory tariff responses against one of its most important customers is ludicrous to begin with, especially given the huge trade deficit that enables the United States to effectively tolerate such a game for far longer and with much less economic damage.

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A head of state recently went to meet with top Chinese leaders for discussions about "compulsory joint ventures, requirements that companies share technical know-how and the inadequate legal protection of intellectual property". A trade organization representative stated "More companies are questioning their commercial commitment to China" and the chief executive of an industrial company said "We in the West need to stand up and tell our friends in China that the way they treat us is no longer working".

Sound familiar? But these were not Americans doing the complaining, they were Germans. These statements were from a recent article in the Wall Street Journal, "As Merkel Visits China, German Businesses Question Their Prospects" (May 23, 2018), which further pointed out that China is Germany's biggest trading partner. Clearly the trade issues with China are not just an American problem since this is the way China conducts international trade in general. Again quoting from the article, "many German executives privately say the U.S. is right to be forceful".

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Major countries around the world are now dealing with trade problems that have been decades in the making. We trust that the goal of any talks and future agreements is to get closer to truly free and fair trade because this is a vital necessity for the global economic pie to grow bigger and allow prosperity to ensue for all participants.

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