The Washington Post

Outlook

Five myths about tariffs

By **Eswar Prasad** March 22

Eswar Prasad is a professor of trade policy at Cornell University and a senior fellow at the Brookings Institution.

President Trump's decision to impose tariffs of 25 percent on steel imports and 10 percent on aluminum imports, followed by his plan to hit China with $60 billion in tariffs, appears to augur a trade war. Worries about the stability of the international trading system have roiled financial markets and led to loud recriminations from Congress, economists and foreign leaders . As with many economic policies, tariffs can create winners, losers and lots of misconceptions.

MYTH NO. 1

Tariffs will help reduce the U.S. trade deficit.

President Trump seems to believe that taxing imports of certain goods, which would raise their prices and reduce demand, will bring down the trade deficit. He tweeted that the North American Free Trade Agreement (NAFTA) "has been a bad deal for U.S.A." because of our "large trade deficits." The AFL-CIO supports this view. And it's true that the U.S. trade deficit, which represents the excess of imports over exports, was $566 billion last year (or nearly 3 percent of annual gross domestic product). Blocking imports seems like a simple way of fixing the deficit.

It's not. Retaliatory trade barriers put up by other countries would hurt U.S. exports and offset reduced imports, meaning the trade deficit wouldn't vanish. What's more, lower exports would mean less employment — a possible unintended consequence of Trump's policy.

Trade deficits are ultimately a result of macroeconomic policies that influence how much a country produces and consumes. When a nation consumes and invests more than its annual output, it has to run a trade deficit. A temporary deficit is not a bad thing if it reflects good investment opportunities or strong income growth that leads people to spend more money. But a trade deficit fueled by large government budget deficits can be harmful.

Reducing government borrowing and helping U.S. firms boost their productivity (meaning they could better compete abroad) would do a lot more to shrink the trade deficit than anything else. Getting other countries to drop their trade barriers would certainly help, but doing this through bilateral and multilateral agreements is likely to be more successful than simply raising tariffs.

MYTH NO. 2

The United States would win a trade war.

A trade war is an escalation of tit-for-tat trade restrictions imposed by two or more countries on one another's exports. Trump has argued that trade wars are "good, and easy to win," especially since the United States imports a lot more from many of its trading partners than it exports to them. Some analysts, such as Robert E. Scott of the left-leaning Economic Policy Institute, argue that other countries won't even dare engage in a trade war with America. This past week, Treasury Secretary Steven Mnuchin asserted that "the United States is the largest trading market," implying that it has more leverage than other countries.

But shutting down trade with any country would lead to collateral damage. A trade war wounds all combatants: It rattles business and consumer confidence, restrains exports, and hurts growth. Many U.S. businesses rely on low trade barriers to create international supply chains that reduce costs and increase efficiency. These could come apart amid the new tariffs. The last time the United States imposed sweeping tariffs, in the 1930s, the effect was to prolong and worsen the Great Depression. Winning a trade war by destroying both imports and exports would be a Pyrrhic victory.

MYTH NO. 3

Tariffs are powerful negotiating tools.

Tariffs are often seen as sticks that increase leverage in trade negotiations with other countries. The message is: If you don't give us favorable terms, we'll hurt your industries. Conservative economists such as Larry Kudlow, who was named Trump's top economic adviser this month, and Arthur Laffer , both of whom have derided tariffs in the past, make this argument. Trump's threats seem to have softened China's position in talks with the United States; Beijing has signaled that it may open more of its markets to American goods and better protect the intellectual property of U.S. companies.

This is a dangerous game, since even the threat of such action opens the door for other countries to consider unilaterally protecting their own industries through similar measures. Former U.S. trade representative Michael Froman notes that other capitals could block imports of U.S. agricultural products on the grounds of food security, thereby improving their negotiating positions. The European Union has threatened tariffs on American bourbon, peanut butter, cranberries and orange juice. The mere uncertainty fomented by Trump hurts U.S. businesses that rely on intricate international supply chains.

All countries, even long-standing trading partners and allies, now have reason to reevaluate their economic relationships with the United States, which looks like an untrustworthy partner. After Trump pulled out of the Trans-Pacific Partnership, the other 11 countries in that arrangement moved on without Washington; they'll benefit from easier access to one another's markets for their exports at a moment when we're the ones saying we need to export more.

MYTH NO. 4

Tariffs are an unfair, illegal strike against trading partners.

Foreign officials, such as European Union Trade Commissioner Cecilia Malmstrom, have labeled Trump's tariffs unfair and a violation of World Trade Organization rules. A Chinese official blasted the proposed tariffs against China as a "wrong practice" and groundless.

The WTO permits tariffs under certain conditions, including when a country faces unfair competition from trading partners; other nations have tariffs on many products, often at higher levels than ours. China has skirted WTO rules and not met its commitments to open up its domestic markets, so the WTO has okayed previous tariffs against it. The body even allows trade sanctions based on national security considerations in exceptional circumstances, such as war or some "other emergency in international relations."

The problem is that Trump's tweets suggest that his tariffs are really focused on economic objectives, not national security. This pretext opens the door for other countries to use similar grounds to impose retaliatory sanctions, undermining the rules of the global trading system.

MYTH NO. 5

The tariffs will not help the steel and aluminum sectors.

Some economists think tariffs are so terrible that nothing good can come of them. "Targeting bilateral trade deficits makes no sense and can be counterproductive," Washington Post contributor Jared Bernstein wrote on his personal blog this month. Even some aluminum industry leaders have expressed reservations about whether the tariffs will help their businesses. In a headline, the Aluminum Association called "Across-the-Board Tariffs A Missed Opportunity on Industry Trade Challenges."

In fact, they will help. By limiting imports, which accounted for about one-third of steel demand and nearly 90 percent of primary aluminum demand in the United States last year, the tariffs will lead to higher prices in the United States for both metals. This will be great for steel and aluminum company profits. Indeed, stock prices of companies in these industries jumped when the tariffs were announced as investors anticipated higher profits in the coming years. Unfortunately, this won't do much for employment in these industries, which are becoming highly automated. Moreover, higher prices will be passed on to consumers who buy metal things, such as cars, machinery and construction materials. This will hurt employment in those sectors and could reduce the demand for steel and aluminum.

Twitter: @EswarSPrasad

Five myths is a weekly feature challenging everything you think you know. You can check out previous myths, read more from Outlook or follow our updates on Facebook and Twitter.

Eswar Prasad is a professor of trade policy at Cornell University and a senior fellow at the Brookings Institution.
Follow @EswarSPrasad