ECONOMIC RESEARCH

The Challenge of Predicting Tariffs' Impact

May 15, 2018

Once upon a time, tariffs—the fees levied on imported goods—were revenue-raising instruments for the federal government as much as protection for fledgling American industries.

Hefty tariffs were the U.S. government's primary source of revenue from 1790 to 1914, pointed out Federico Mandelman, an Atlanta Fed research economist.

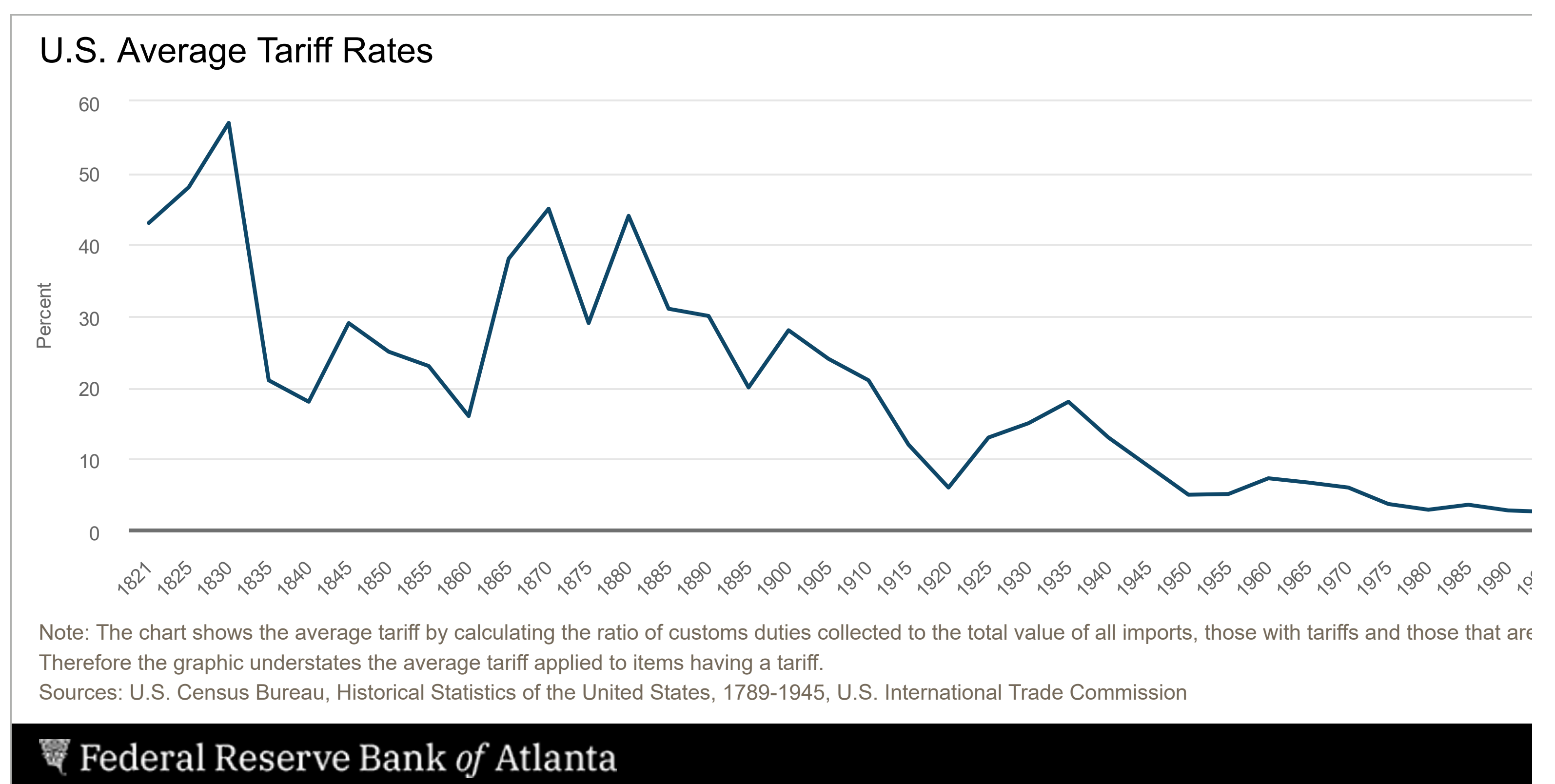
Put simply, in the 1800s, America was the protectionist on the world's economic stage, and the United Kingdom was the major free trader. At the turn of the 20th century, according to the World Trade Organization (WTO), the average tariff level in the United States was 32.5 percent, more than double that of the United Kingdom, France, Germany, and Japan.

Over time, movement away from tariffs

Protectionist measures proliferated amid the Great Depression, in which the U.S. economy shrank by nearly 25 percent. Former Fed Chairman Ben Bernanke, a noted scholar on the Great Depression, has said economists agree that the Smoot-Hawley Tariff Act of 1930 "and the ensuing tariff wars were highly counterproductive and contributed to the depth and length of the global Depression."

Coupled with collapsing demand, these new barriers caused the value of international trade to plummet by two-thirds between 1929 and 1934, according to League of Nations data cited by the WTO. "That trade war didn't benefit anyone," Mandelman said.

But in the past several decades, major global economies have dramatically reduced or even eliminated tariffs. After the Great Depression and World War II, world powers led by the United States focused on constructing an economic order based on open trade and economic integration. Tariffs in the United States, the United Kingdom, France, Germany, and other major economies fell sharply. Today the broad average U.S. tariff rate is about 1.5 percent. (see the chart)



Global trade since World War II has been reasonably free and, consequently, has steadily grown. In 2017, international trade—the sum of U.S. imports and exports—equaled 27 percent of the nation's gross domestic product, up from 19 percent in 1990 and just 9 percent in 1960, according to data from the U.S. Census Bureau and the U.S. Bureau of Economic Analysis.

Tough to pinpoint tariffs' effects

A huge majority of economists—as many as 99 percent, Mandelman figures—view trade restrictions as inadvisable. In recent months, Atlanta Fed president Raphael Bostic and other Reserve Bank leaders have said proposed tariffs and possible retaliation against them from other countries could dent economic growth.

In a May 9 speech, Bostic said that based on his conversations with businesspeople in the Southeast, he thinks uncertainty about trade policy may be causing corporate leaders to delay some capital investments.

"I want to reinforce that I am talking about the uncertainty associated with the current trade discussions and not the specifics of any particular policy or policies," Bostic told the Jacksonville, Florida World Affairs Council Global Business Luncheon. "Indeed, trade policy is never as clear-cut as most of us would hope."

Still, Mandelman said that predicting the macroeconomic effects of tariffs that the United States could impose is difficult. Part of the difficulty stems from the overall absence of tariffs in recent years, offering economists little to study. And the limited available evidence is not especially helpful, he added.

Trade has increased dramatically and changed fundamentally since tariffs were widespread 100 years ago. International trade today is mostly in intermediate parts and services, not finished goods such as automobiles built entirely in one country. Components like auto parts, memory chips, and hard drives make up 56 percent of trade in goods among developed countries, according to the Organisation for Economic Cooperation and Development (OECD). In trade of services, "intermediates" are even more dominant, making up 73 percent of flows among OECD countries.

Federico Mandelman

Trade restrictions did not entirely disappear after World War II. They took different, typically less onerous forms than tariffs, though. For example, in the 1980s, the Reagan administration convinced Japan to limit the number of cars exported to the United States. Other countries have imposed strict safety standards, subsidies for home-country producers, labeling requirements, and other techniques largely aimed at insulating domestic industries from imports, Mandelman explained.

The amorphous nature of these modern-day trade barriers makes them hard to measure, Mandelman noted, further complicating predictions of how new trade conflicts might affect the macroeconomy. Economists have not extensively researched such less formal protectionist practices. If economists can't quantify something, they generally don't research it because there is little reliable raw material to work with. Consequently, Mandelman added, there's not a great deal of solid research on the influence of more informal, nontariff trade restrictions.

Economic theory offers clues

Though recent experience with tariffs is limited, economic theory offers several clues about their effects. First, tariffs would tend to decrease overall consumption and economic output globally, as fewer varieties of products will be produced, and these will be produced with diminished efficiency.

Ideally, Mandelman explained, trade is based on comparative advantage. Germany builds great cars. The United States

manufactures excellent jet planes. Italy produces some of the world's best wine. So countries specialize where they have an advantage compared to other countries and export their specialties, which they produce very efficiently.

"When you import from other countries, you are getting the best in the world from those countries," Mandelman said.

Limit imports, and you interfere with productivity and efficiency, limiting consumers' access to the high-quality products or services from abroad, Mandelman said. "For instance, if Germany places big tariffs on Italian wine, then Germans will make more of their own wine. It won't be as good as the imported variety, nor will it be the best use of German workers' skills."

Although Mandelman estimates that 99 percent of economists view free trade as beneficial overall, it has downsides. Most notably, "you have winners and losers." Indeed, the popular conception that global trade has led to the elimination of jobs, especially in fields like manufacturing, is not entirely misguided, he said. The especially difficult byproduct of free trade is the transition period between job losses in fields like textile or furniture manufacturing, and the replacement of those jobs by other occupations, Mandelman noted.

Those transitions create multifaceted challenges. Confronting those challenges, Bostic noted, requires a coordinated workforce development system that partners with the private sector and programs that encourage innovation and entrepreneurship. The Atlanta Fed's Center for Workforce and Economic Opportunity is contributing to this effort by helping to build a bridge between research and practice. It connects researchers, businesses, and policymakers with innovative approaches to creating economic opportunity through education and employment.

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