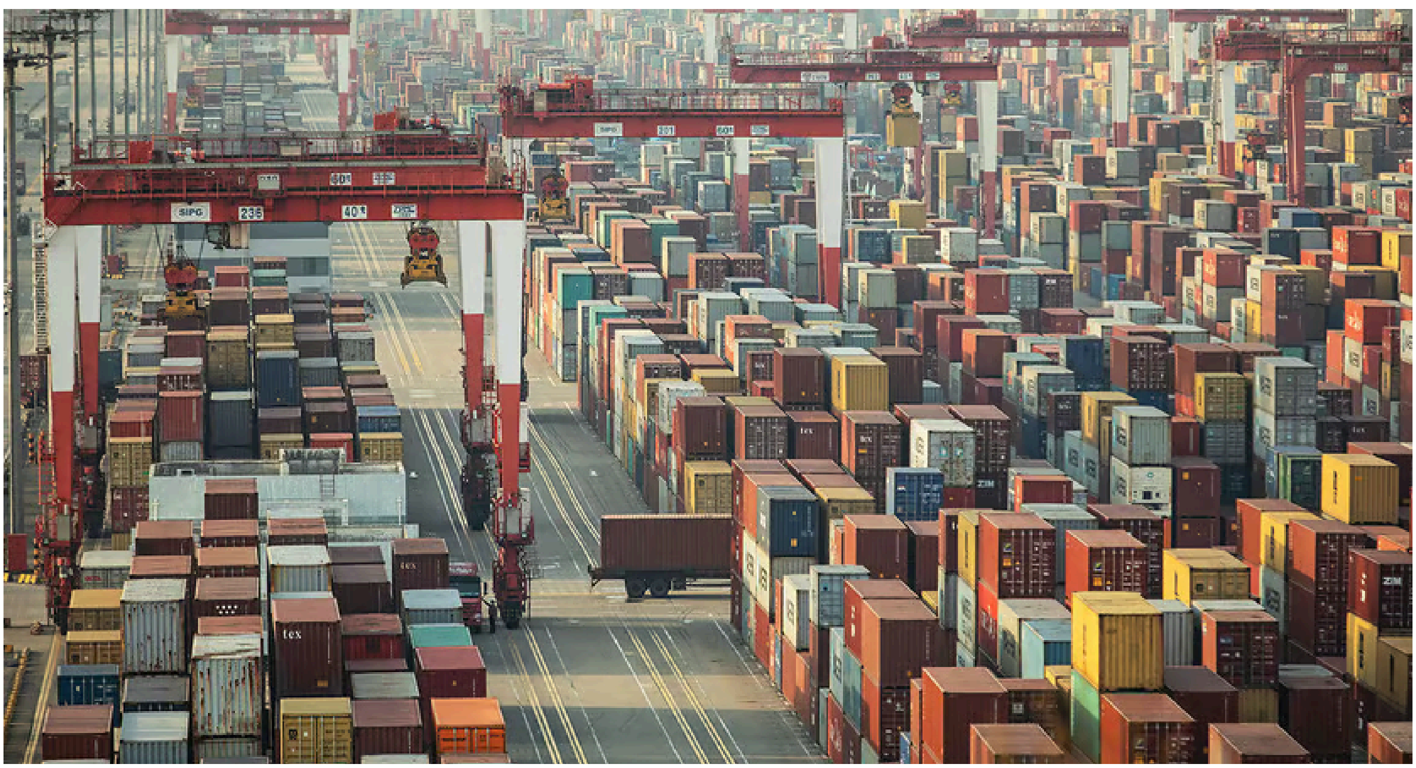
Finance & economics | Mercantilist menace

Tariff uncertainty can be as ruinous as tariffs themselves

Whatever its geopolitical merits, the “madman theory” transfers badly to economics



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AMERICA'S PRESIDENT tempts many people to invoke the "madman theory" of diplomacy. In dealing with other countries, it helps if they think you are crazy. By making threats credible even if they would harm your own country, such a reputation will let you win games of brinkmanship.

Whatever its geopolitical merits, the madman theory transfers badly to economics. Crazy leaders are hard to predict. Unpredictability creates uncertainty. And uncertainty kills investment and hiring, at home as well as abroad. In trying to win a bigger share of the spoils, brinkmanship ensures there are fewer spoils to be won.

Donald Trump's approach to trade illustrates the point. Since his election victory he has threatened a bewildering array of tariffs, ordered duties on Canada and Mexico, suspended these orders, then placed tariffs on China. Dario Caldara of the Federal Reserve and colleagues calculate the share of articles in (mostly) American newspapers containing words such as "tariff" or "import duty", together with words like "uncertainty" or "dubious". According to their index, uncertainty was higher in the past three months than at any point since the data begins in 1960.

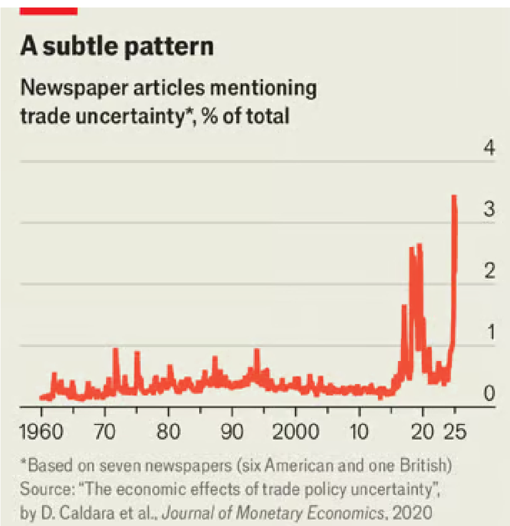

CHART: THE ECONOMIST

Uncertainty makes a virtue out of hesitation. Imagine a firm looking to build a factory in China or Mexico to support an American expansion. When Mr Trump threatened tariffs of 60% on China last year, the firm might have favoured Mexico. When he then promised tariffs of 25% on Mexico and only 10% on China, it might have turned to China. After he delayed the Mexican tariffs and implemented the Chinese ones, it could be forgiven for doing nothing at all until things settled down. Watchful waiting is prudent for the firm, but damaging for the economy. Even if the factory eventually opens, the production lost to delay will never be recovered.

or suppliers, adapting to idiosyncratic needs. Such "sticky" relationships between French firms and European partners account for a disproportionate share of trade, according to Julien Martin of the University of Quebec in Montreal and co-authors. Some relationships last more than six years. That is longer than many French marriages. But when uncertainty rises, companies are less likely to pair off with one another.

The economic stakes can be illustrated by looking at market reactions to Mr Trump's earlier trade wars. Mary Amiti of the New York Fed and her co-authors point out that the American stockmarket fell by a combined 12% on the 11 days in 2018 and 2019 when tariffs were announced by America or China. That wiped over $4trn from firms' market value. By looking at the response of options prices and Treasury yields, the economists calculate that about half the drop reflected a flight to safety and a reluctance to hold risky assets, rather than a simple change in expected profits.

The war also hurt China. Felipe Benguria of the University of Kentucky and his co-authors have scoured annual reports from over 2,000 listed Chinese firms in this period, looking for mentions of tariffs, protectionism or unilateralism, and references to uncertainty, crisis or threats. Business nerves increased by over 300% from 2016 to 2018. The authors distinguish between the "pain" of tariffs and the "anxiety" of uncertainty. They show that the anxiety, even controlling for the pain, had a measurable impact on profits and investment.

China's investors have so far taken Mr Trump's new duties in their stride. For the past few months, they have been braced for worse. Even so, uncertainties remain. Mr Trump's order closes a loophole—the *de minimis* exemption—that allows packages worth less than $800 to escape duties on the grounds that they are not worth the inconvenience of collecting. (The government should not spend a dollar to collect 50 cents, as one official put it in the 1950s.) Chinese e-commerce firms had become adept at exploiting the loophole.

But America's customs agency lacks the machinery or manpower to examine even a fraction of these parcels. And the extra burdens of compliance may be as costly to exporters as the duty itself. Some exporters to America may need to invest in new storage and distribution. Before they make that investment, they will need to be convinced that the loophole will remain closed despite the inconvenience.

Canada and Mexico have a month to sort a deal with America. Even if they succeed, the chaos has cost the three economies, harming the credibility of their trade agreement. The virtue of NAFTA and (to a lesser degree) its successor, the USMCA, is that it ties the hands of governments, giving them the power to limit from mutually beneficial commitments. ■

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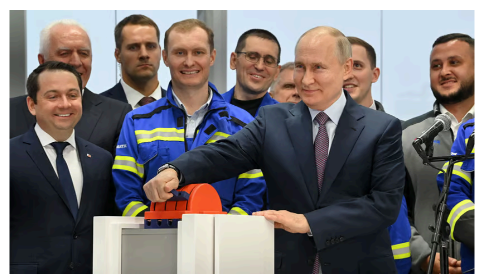

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