Current Economic Conditions

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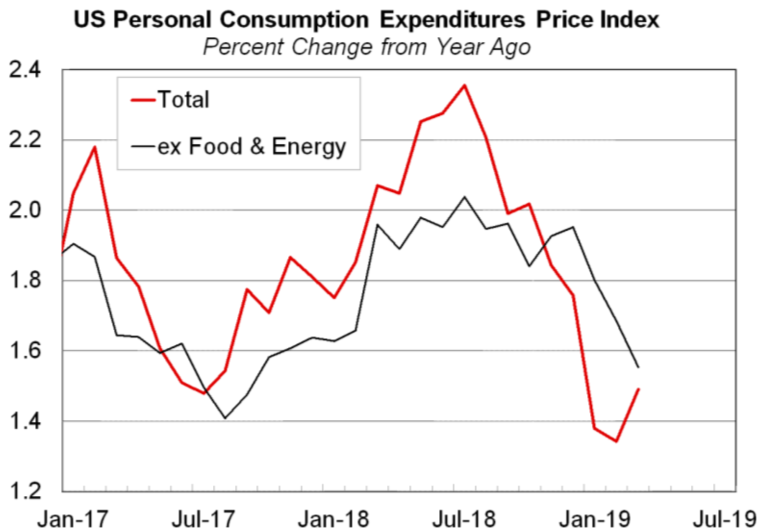
U.S. ECONOMY HAS DONE WELL DESPITE TARIFFS . . . SO FAR

U.S. tariffs of 10% on $200 billion of imports from China don't appear to have caused the economic damage that many of us feared. Real Gross Domestic Product grew at a 3.2% annual rate in the first quarter. Year-over-year growth rose to 3.2%, the best since 2015. Perhaps more surprising, commonly used price indexes do not show a jump in consumer prices after the tariffs were imposed last September. Inflation, as measured by the year-over-year change in the Personal Consumption Expenditures price index, fell from 2.4% last July to 1.5% in March. Excluding volatile food and energy prices, PCE price inflation fell from 2.0% to 1.6%. In contrast, last year's tariffs on washing machines clearly raised consumer prices, and tariffs on steel and aluminum raised costs for U.S. manufacturers, builders, and petroleum companies.



It's theoretically possible that tariffs haven't been as harmful as we expected because of the choice of which Chinese exports to target for tariffs. Even though tariffs are paid by U.S. importers, not by Chinese exporters, the ultimate burden of the tariffs is divided among Chinese exporters, U.S. importers, and U.S. consumers. How that burden is divided – what economists call the "incidence of a tax" – depends on elasticities of supply and demand, i.e., how responsive U.S consumers and Chinese producers and their competitors are to changes in price. If the $200 billion in Chinese exports targeted for tariffs so far were goods that were readily available from sources other than China at comparable prices, Chinese producers would have to cut their prices to continue to sell into the U.S. market. They, not Americans, would bear the burden of the tariffs. Alternatively, U.S. importers could import from somewhere other than China, and Chinese exporters could export to somewhere other than the United States. Shipping costs would rise (with a consequent loss in economic efficiency), but tariffs wouldn't be collected. Regardless of whether Chinese producers bore the tax burden, or the tariff were simply avoided, prices to U.S. consumers would rise by much less than the full value of the tariff. This could explain why tariffs haven't had a big impact.

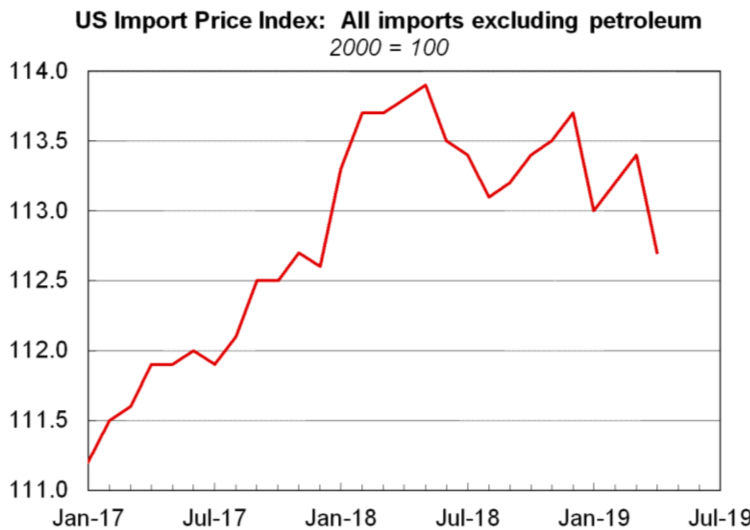
A recent National Bureau of Economic Research working paper casts doubt on this favorable interpretation. It showed that prices of goods affected by the tariffs have risen significantly. The authors conclude that the tariffs have been fully borne by Americans, either through reduced profit margins for importers or higher prices for consumers.

It is more likely that tariffs on Chinese goods have had the expected harmful impacts on growth and prices, but that these impacts have been overwhelmed by other factors. The underlying U.S. growth rate may be much stronger than most forecasters thought because of a rebound in productivity growth from the near-record lows of the 2010-2017 period. This rebound reflects the positive impacts of tax reform and regulation, a decline in oil prices from their 2011-2014 highs, and the fading impact of the financial crisis

on the economy. Growth might have been even stronger if not for the tariffs. Any upward pressure on prices from the tariffs has been more than offset by other factors, including slow growth abroad, which have put downward pressure on prices around the world. The NBER working paper that showed the prices of goods affected by the tariffs rising significantly showed the prices of other goods declining.

Unfortunately, the impact of tariffs on the U.S. economy might not remain muted for much longer. After trade negotiations with China broke down last week, President Trump raised tariffs on ($200 billion of) Chinese goods from 10% to 25%. He is considering imposing tariffs on another $300 billion of Chinese exports. For two reasons, one should not assume that, just because the impact of tariffs seems limited so far, these new actions won't hurt. First, economic theory holds that the deadweight (efficiency) loss from a tax is proportional to the square of the tax rate. A 25% tariff is 6.25 times as harmful as a 10% tariff, not 2.5 times. Furthermore, the $200 billion of goods initially targeted for tariffs were presumably chosen because those tariffs would have a relatively small impact on the U.S. economy. Tariffs on an additional $300 billion of Chinese goods would likely have a much larger impact. The (relatively) painless tariffs have already been implemented. Future tariffs are likely to be much more painful.

If tariffs are imposed on an additional $300 billion of goods from China, costs to U.S. importers will rise. If market conditions allow them to pass on these higher costs to consumers, consumer prices will rise. This will result in a decline in real consumer spending, which accounts for 70% of GDP, and an increase in the reported inflation rate. Technically, the increase in consumer prices resulting from a tariff is a one-time increase in the price level, not an increase in the inflation rate, but it's not clear that the markets will understand the distinction when the reported inflation rate rises. The Fed certainly understands the distinction but might still react to higher measured inflation by raising interest rates to enhance its inflation-fighting credibility and ensure that a one-time increase in prices doesn't get built into inflation expectations. If market conditions don't allow U.S. importers to pass higher costs on to consumers, as was the case with tariffs on steel and aluminum, profit margins will be squeezed. Lower profits will result in both weaker business investment and lower stock prices. Investment in equipment seemed to fall in response to the imposition of 10% tariffs last September. Stock prices fell 20% last fall, but it's hard to tell how much was due to tariffs and how much was due to monetary policy mistakes and weaker growth abroad. Stock prices have fallen again this month in response to higher tariffs and the breakdown in trade negotiations.



My forecast was that trade concerns would suppress growth in the first half of 2019 but that growth would pick up in the second half after a trade agreement between the United States and China eliminated the risk that tariffs would go up to 25% and be extended to another $300 billion of Chinese exports. Growth didn't slow as much as I expected in the first quarter, but April data on retail sales and industrial production suggest a slower second quarter. The assumption underlying the second-half rebound has turned out to be wrong, **at least for now**. Underlying trend growth rate is stronger than the pessimists thought, and a nascent rebound in housing market activity still points to a second-half acceleration, but with tariffs up to 25%, the risks to the forecast are to the downside. Extending the tariffs to another $300 billion of Chinese goods would significantly increase the downside risk. This does not mean that President Trump should back down in trade negotiations with China. Getting China to respect the intellectual property of American companies is worth a hit to the stock market and a few quarters of weak economic growth. But it does mean that despite low inflation and strong first-quarter GDP growth, tariffs are bad for the U.S. economy.

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