THOUGHT FOR THE WEEK

Can tariffs 'steel' the market's thunder?

SUMMARY

- Politicians are angry. Economist on the left and right are deeply skeptical. The culprit: tariffs on imported steel and aluminum to protect American national security and revive U.S. manufacturing. Additional tariffs are also being considered for Chinese imports, targeting technology, telecom and apparel sectors.
- The stock market was (reasonably) rational with its reaction, immediately tumbling upon hearing the tariff news on steel and aluminum, then rallying as the implications were digested. However, news on additional potential tariffs targeted on China intensified fears of a trade war and rattled the markets.
- At a minimum, these tariffs will impact those firms, industries, and states that depend on steel and aluminum imports, which at this point is still a relatively small segment of U.S. trade. The real risk remains to be seen if trade partners respond with their own retaliatory tariffs on a broader set of export industries.

The big news on Wall Street recently has been all about tariffs. President Trump is imposing a 25% tariff on imported steel and a 10% tariff on imported aluminum to protect the U.S. from other countries' trade practices that may endanger national security. The tariffs are effective March 23rd. Currently, only Canada and Mexico are exempt, but Trump left the door open for other countries to receive exemptions as well. The news on the tariffs has been widely criticized by politicians, businesses, economists and foreign nations. There have also been talks of an impending trade war. The markets dropped initially when the tariffs did not include the exclusions for Canada and Mexico, on concerns that a trade war could create an unfavorable environment for global growth, one of the pillars of bull markets around the world. The potential for additional tariffs on China surfaced this week, reigniting the fears of retaliation from some trade partners. Here's what you need to know regarding the currently imposed tariffs on steel and aluminum, starting with the basics.

What is a tariff?

A tariff is simply a tax or duty to be paid on a class of imports or exports. Tariffs are typically used by a government to make money or protect domestic industries. Under the current scenario, the tariffs would cost a company importing $100,000 of steel made in a non-exempt country into the United States an additional $25,000 to be paid as taxes to the U.S. government.

What is the rationale?

American steel and aluminum companies have long complained of unfair practices by overseas competitors, especially Chinese state subsidies that encourage production. This can flood the global marketplace with metals, depress prices and make American production less economical. The idea here is that the imposition of tariffs would level the playing field between the United States and countries like China. In other words, the tariffs would make it more expensive to buy foreign steel, thus providing American steel producers with equal footing or pricing parity.

How do Trump's proposals differ from past tariffs?

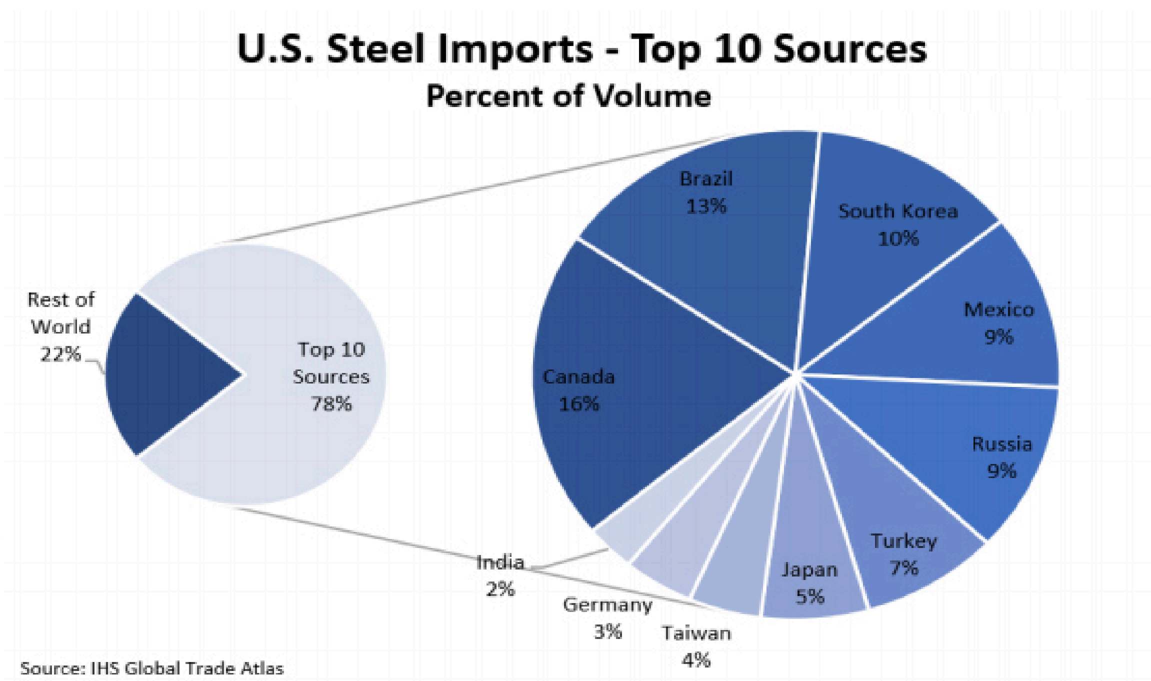
Tariffs in the United States have played an important role in trade policy and the nation's economic history. The first tariff in the U.S. was enacted in 1789, signed into law by President George Washington. More recently, the administrations of George W. Bush and Barrack Obama both applied steel tariffs. Bush imposed broad tariffs of up to 30% on steel imports in 2002. These were meant to last three years but were withdrawn early, after the World Trade Organization (WTO) ruled against them. Meanwhile, Obama applied tariffs of up to 522% on some Chinese steel in 2016 to prevent China from dumping cheap steel. Trump's proposal is different in that previous tariffs targeted specific countries, such as China. Trump has provided exemptions to countries like Canada and Mexico, but his tariffs are broader in the targeted countries.

Who wins and who loses?

American steel and aluminum manufacturers will benefit from the tariffs, while industries that rely on steel and aluminum as an input could be hurt by rising prices. The tariffs would raise the cost of raw materials for industries such as automakers building the chassis of a car, or aerospace building the wings of an aircraft, as well as for heavy equipment manufacturers and construction companies. For any given product, it's difficult to predict whether the producers will eat the cost or pass it on in the form of higher prices, or both.

What does this mean for the economy?

The American economy is relatively strong at the moment and has been historically resilient to most disruptions. Looking back at the 2002, Bush administration steel tariffs were certainly costly in terms of lost jobs, but they did not lead to an economic recession. In 2017, imports of steel and aluminum goods totaled nearly $48 billion, or about 2% of total U.S. imports, according to a study by Brookings Institution. The tariffs may end up creating some jobs in the metals-producing industries, costing some jobs in fields where steel and aluminum are used, and pushing consumer prices a bit higher.



The real risk is not the potential increase in costs for steel and aluminum, but rather whether this would trigger a trade war. According to the Department of Commerce, the U.S. is the world's largest steel importer. The top four countries that send steel to the United States are Canada, Brazil, South Korea and Mexico. (China is only the eleventh largest.) The top four countries that send aluminum to the U.S. are Canada, Russia, the United Arab Emirate and China, according to the United States Geological Survey. While Canada and Mexico are exempt from the new tariffs, many countries – including China and those in the European Union – are developing plans to retaliate. Retaliatory tariffs could hurt other U.S. industries. The tariff also opens the door to other countries following America's lead and claiming they need to protect some of their domestic industries.

Bottom Line

It is too early to tell if the proposed tariffs are likely or unlikely to achieve their intended goals of pressuring countries suspected of creating market distortions from subsidies and dumping. If history is any guide, tariffs have not proven effective. At a minimum, these tariffs will impact those firms, industries, regions and states that depend on steel and aluminum imports, which at this point is still a relatively small segment of total U.S. trade. If trade partners respond with their own retaliatory tariffs on a broader set of export industries, there could be larger unintended consequences. Financial markets reacted relatively calmly to the prospect of the imposed steel and aluminum tariffs, indicating that investors don't expect them to lead to a broader trade war. However, we can expect volatility to remain elevated as concern over a trade war lingers. For now, we can take solace in the fact that President Trump's next top economic adviser, Larry Kudlow, who is a free trade advocate, may help ratchet down the escalating tariff trade war.