Current Economic Conditions

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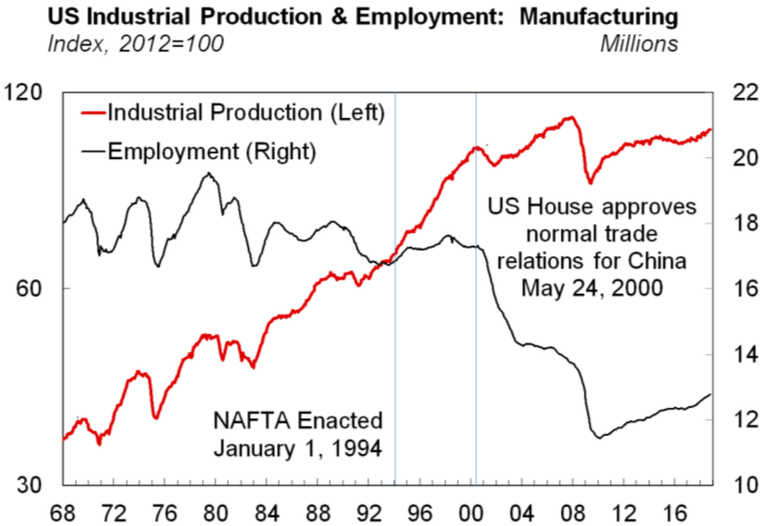
RIGHT WAR, WRONG WEAPON

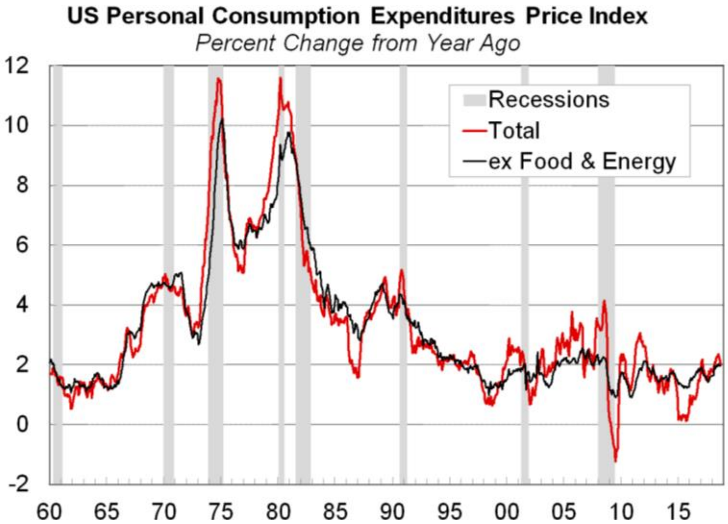
If a picture is worth a thousand words, the chart below is worth almost as much as the rest of this newsletter. On a chart of industrial production and employment in U.S. manufacturing, I've labeled two dates: January 1, 1994, when the North American Free Trade Agreement (NAFTA) was enacted, and May 24, 2000, when the U.S. House of Representatives approved permanent normal trade relations with China, paving the way for China to join the World Trade Organization (WTO). A quick look at the chart shows no evidence that NAFTA adversely affected U.S. manufacturing. Industrial production **accelerated** after NAFTA was enacted. Individual companies and workers might have lost business and jobs because of NAFTA, but the manufacturing sector as a whole did not. (And as the chart on page 2 shows, NAFTA seems to have held down inflation in the United States since 1994.) When President Trump calls NAFTA "the worst trade deal ever," he's wrong.



China is a different story. Rarely does one find such easily identifiable kinks on a chart. In the 77 months from the enactment of NAFTA to the approval of permanent normal trade relations with China, industrial production in U.S. manufacturing grew at a staggering 6.0% annual rate, the fastest growth since the 1960s. Since then, production has grown at just a 0.3% rate, with almost all the growth since 2016. Even before the Great Recession, in the period from May 2000 to December 2007, industrial production grew at just a 1.5% rate. Employment in manufacturing, which had been in a mild downtrend since 1979, fell precipitously after China was granted permanent normal trade relations.

Some of the pain inflicted on U.S. manufacturing by allowing China to join the WTO **and then not enforcing the conditions for WTO membership** was simply due to companies' moving production or supply chains to China in response to lower costs, particularly lower labor costs. This is nothing unusual; companies have been moving operations in search of lower labor costs since the dawn of the industrial revolution. An undervalued yuan, the result of a huge devaluation on January 1, 1994, also hurt U.S. manufacturing in the first few years after the United States granted permanent normal trade relations to China. What sets China apart from the cheap labor costs and undervalued currencies typical of developing countries is the magnitude of forced technology transfers and intellectual property theft. In many industries, foreign companies have been forced to form joint ventures with Chinese companies in order to do business in China and to share their technology with their JV partners. Worse yet, Chinese companies have used intellectual property (e.g., patented manufacturing processes) stolen from foreign companies.

President Trump was elected largely because he promised to stop the loss of U.S. manufacturing jobs (and production). While he too often views trade issues through the cloudy prism of the trade deficit – the United States will run a trade deficit as long as the dollar is the main reserve currency, and giving up reserve-currency status to shrink the trade deficit would be a costly mistake – and while he has been unfairly critical of NAFTA and the Trans-Pacific Partnership (TPP), his criticism of Chinese trade practices has been largely correct and totally justified. The President and his trade negotiators need to make it clear that forced technology transfers and intellectual property theft must stop. (Reducing the trade deficit by getting the Chinese to buy more U.S. goods would be a nice bonus but isn't as important.)



My quibble with the Trump Administration's approach to China is over weapons rather than over goals. The President has imposed 10% tariffs on most goods imported from China. Those tariffs are scheduled to rise to 25% on January 1, 2019. These tariffs will hurt a Chinese economy that is already slowing – that's their intent – but they will also hurt U.S. consumers and businesses that import goods from China. Tariffs on finished goods will either raise consumer prices (and measured inflation) or reduce profit margins for American retailers. If the former, the Federal Reserve might raise interest rates more than currently planned; that could end the economic expansion. If the latter, stock prices will fall. Tariffs on intermediate goods are even more harmful. U.S. manufacturers that must pay a tariff on intermediate goods imported from China will have a difficult time competing with companies in other countries that don't pay the tariff. Economists use a measure called "deadweight loss" to measure the losses caused by a tax. Deadweight loss is proportional to the square of the tax rate. Thus, a 25% tax is 6.25 times as harmful as a 10% tax, not 2.5 times. If the impact of the current 10% tariffs seems trivial, one should not conclude that 25% tariffs won't cause serious damage.

This month, the Trump administration announced indictments against Chinese (and Taiwanese) companies and individuals for stealing intellectual property from Micron. This approach was viewed as a supplement to tariffs and an escalation of the trade war. It should have been the first weapon deployed. Our former colleagues who have stolen intellectual property from our employers should go to jail for a long time. But I'd go further. I'd prohibit companies that use stolen intellectual property (and companies that buy from such companies) from selling goods in the United States. Such measures would have far more impact on Chinese companies at far less cost to U.S. businesses and consumers than tariffs would.

But as much as I dislike tariffs, China is a special case that must be dealt with. China has been engaged in a trade war against the United States since the 1994 devaluation of the yuan. That war escalated when China was allowed to join the WTO. China's actions have been more egregious and its impact on the U.S. economy much larger than those of any other country. I prefer other weapons for fighting a trade war, but tariffs are better than doing nothing to save U.S. manufacturing. People who oppose President Trump, either generally or specifically on trade issues like NAFTA, TPP, and tariffs on steel and aluminum, should back him on this one.

While concerns about tariffs and interest rates have roiled financial markets, the real economy grew strongly through October. Real Gross Domestic Product grew at a 3.5% annual rate in the third quarter, due largely to consumer spending. Retail sales were strong in October. Consumers might be buying ahead of anticipated price increases. Payroll employment rose by 250,000 in October after a hurricane-depressed reading in September. Industrial production in U.S. manufacturing rose another 0.3%. Despite strong growth and declining unemployment, inflation has eased in recent months and will likely fall further due to the recent decline in oil prices. But this might be the calm before the storm. If tariffs on Chinese goods rise to 25% on January 1, inflation will rise, and economic growth will slow. Tariffs will benefit the U.S. economy if and when they convince China to change its behavior. Until then, they will hurt.