



Trade War Hysterics

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Since hitting new all-time highs two weeks ago, the S&P 500 has fallen about 2.2% as trade negotiations with China hit a snag. Last week, the US announced new tariffs on Chinese imports. This morning, China announced new tariffs on some US goods. Many fear a widening trade war.

Don't get us wrong. We want free trade, and we understand the dangers of trade wars and tariffs (which are just taxes on consumers). At the same time, we think trade deficits themselves are not a reason for trade wars. We all run personal trade deficits with the local grocery store and benefit from that. Even if the entire world went to zero tariffs, the US would almost certainly still run trade deficits, even with China.

But today, the trade deficit with China is partly due to the fact that China has higher tariffs on imports than the US does – working to eliminate these lopsided tariffs is worthwhile.

In 1980, China was an impoverished nation. Then it began adopting tools of capitalism – property rights, markets, free prices and wages. Chinese businesses started to import the West's technology, and growth accelerated.

Initially, China didn't have to worry about intellectual property. When you replace oxen with a tractor, all you have to do is buy the tractor, not reinvent the internal combustion engine. But China has now picked, and benefited from, the lowest hanging fruit. So, China decided to steal the R&D of firms located abroad. Some estimates of this collective theft run into the hundreds of billions of dollars.

That's why normal free market and free trade principles don't neatly apply to China.

Remember President Reagan's old story supporting free trade? "We're in the same boat with our trading partners," Reagan said. "If one partner shoots a hole in the boat, does it make sense for the other one to shoot another hole in the boat?" The obvious answer is that it doesn't, and so our own protectionism would hurt us.

But China hasn't just shot a hole in the boat, they've become pirates. If Tony Soprano and his cronies robbed your house, would free market principles require you to trade with them to buy those items back? Of course not!

It's true tariff increases will not help the US economy. But \$100 billion of tariffs spread over \$14 trillion of consumer spending is not a recession inducing drag. It's true some business, like soybean farmers, are hurt. But the status quo means accepting hundreds of billions in theft from companies that are at the leading edge of future growth.

Either way, if tariffs nick our economy, China's gets hammered. Last year we exported \$180 billion in goods and services to China, which is 0.9% of our GDP. Meanwhile, China exported \$559 billion to the US, which is 4.6% of their economy. We have enormous economic leverage that they simply can't match.

An extended US-China trade battle means US companies will shift supply chains out of China and toward places like Singapore, Vietnam, Mexico, or "Made in the USA." If that happens, the Chinese economy is hurt for decades.

Anyone can invent a scenario where some sort of Smoot-Hawley-like global trade war happens. Realistically, though, that appears very unlikely. We're not the only advanced country China's piracy has victimized, and China may realize it's more isolated than it thought. In the end, China wants to trade with the West, not North Korea, Russia, and Venezuela. China needs the West. And all these trade war hysterics just aren't warranted.

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