***Remarks at Hong Kong Association of New York/Ernst & Young panel event on "Challenges and Opportunities for Other Countries in the Midst of the US-China Trade Tension"* at EY offices, Thursday June 27, 2019, New York City**

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The Trump administration has not been shy about using tariffs, either imposing them or threatening to, in its trade disputes with China and with other trading partners. As the economist on the panel,[1] I thought I would set the stage by making a few comments on how economists think about tariffs and their effects.

A tariff is just a tax on goods and services that move across nation state borders, so, while that has some special implications, tariffs can be analyzed like any other tax. A tariff on imports drives a wedge between the price that the (domestic) consumer pays and the price that the (foreign) seller receives. The tariff raises the price that the consumer pays and lowers the prices that the seller receives, with the difference (multiplied by the amount of imports) going to the government as tax revenue.

Because domestic producers of the same good don't pay the tariff (only the foreign producer does), the tariff also drives a wedge between the prices that domestic producers and foreign producers, respectively, face. This means that, although the amount demanded by consumers, and therefore sold, goes down, because the price to consumers goes up, more of this output is supplied by domestic producers. This is the whole point of tariffs: to "protect," that is, raise the output of, domestic producers. Foreign producers face a double whammy: the overall amount demanded goes down and domestic producers take some market share.

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[1] The other panelists were: Lanier Saperstein, Partner, Dorsey & Whitney LLP; Gabriel Wildau, Senior Vice President, Teneo; and Helen Xiao, Senior Manager, Ernst & Young, LLP, and the moderator was Douglas Bell, Global Trade Policy Leader, Ernst & Young, LLP.

Economists tend not to like tariffs (or taxes in general, unless there is a good reason for having them: to correct for negative externalities and to redistribute income), because these tax wedges result in a less efficient configuration of production and consumption. It is the resulting so-called “deadweight losses”[2] that economists don’t like. Because tariffs drive up the domestic price and therefore drive down the amount consumed (because demand curves in price-quantity space slope downwards), they result in a social welfare loss: the “consumer surplus” and the “producer surplus” foregone on the lost output.[3]

More consumer surplus and producer surplus is lost than that, but part of these losses is just a transfer to the government as tax revenue, so economists do not typically view this as a net social loss.

The funny thing about these deadweight losses – the things that economists really dislike – is that they are never observed; rather they are in the realm of “what if” counterfactuals.

The questions of the deadweight losses, and how big they are, is different from the hotly debated issue of “who pays the tariff?” Here again viewing a tariff as a tax is helpful because a key insight of the economics of taxes is that where the tax is imposed (who nominally pays it) and where the tax falls (who actually ends up paying it) are two different things. The standard answer is that how much of the tax (tariff) results in a higher price to the consumer and how much results in a lower price for the producer depends on the relative elasticities of demand and supply (intuitively, how responsive they are to price changes).

This raises another key point: it is important to distinguish the short-run effects of tariffs from their long-run effects. Supply elasticities will tend to be higher in

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[2] These are also known as “Harberger’s triangles,” after the Chicago University economist, Arnold Harberger, who popularized them.

[3] “Consumer surplus” refers to the gain to consumers from having to pay for a good than the value they put on it (the maximum amount they *would* be prepared to pay for it). “Producer surplus” refers to the economic rent (profits) that producers receive by being able to sell a good for more than it costs them to produce, including the normal economic profits needed to compensate the suppliers of capital.

the long-run. In the short-run, producers are more likely to absorb the tariff in their profit margins rather than by cutting back on supply (as in the above analysis), but over time, capital being mobile, more of the cost of the tariff is likely to fall on consumers.

The response of producers, both domestic and foreign, depends also on whether they expect the tariffs to be temporary or permanent. One of the negative impacts of tariffs, when they are imposed or threatened, is to raise uncertainty about whether the tariffs will be temporary or permanent. This, in turn, will put a damper on investment, as firms wait to see how that uncertainty is resolved. The uncertainty surrounding tariffs, particularly if it is prolonged, rather than the steady-state deadweight losses themselves, may do the greater economic harm, particularly in the short-term.

There is an important political economy aspect to the winners and losers from tariffs. Suppose we are in the long-run: permanent tariffs are in place, prices have adjusted, and consumers have adjusted their consumption baskets and producers have adjusted their capital stocks. The welfare losses to consumers are diffuse and quite intangible: they end up having a less efficient consumption basket than they otherwise would have and their real living standards are a little lower than they would have been. The gains to the producers and their workers in the tariff-protected industry – the producers who would not have invested and hired those workers were it not for the tariffs – are concentrated, however.

Recall that, if only about 78,000 voters in Pennsylvania, Michigan and Wisconsin who voted for Donald Trump in the 2016 presidential election had voted for Hillary Clinton, the outcome of the election would have been different. A relatively few happy workers politically can outweigh an awful lot of slightly impacted consumers.

Finally, a word on the likely macroeconomic impact of a prolonged and escalated "trade war" between the US and China. The experience of the Great Depression, and the complicity of the notorious Smoot Hawley tariffs (of 1930), is often invoked to warn of the dire consequences of a tariff war. These fears are probably overstated.

For one thing, both the US and China, particularly the US, are large domestic demand-oriented economies, meaning that disruptions to trade should not necessarily trigger a serious downturn for the whole economy. Exports comprise about 12% of US GDP and about 18% of China's GDP, and US exports to China are only about 1% of US GDP and China's exports to the US about 3 to 4% of its GDP. That said, China is probably more susceptible to a prolonged trade war, given its less advanced stage of economic development and the large build-up of debt and credit in the economy.

For another, the job of the Federal Reserve is to maintain full employment and low stable inflation (of around 2%) and it will adjust its monetary policy to offset any negative impacts on the macro-economy from trade disruptions. Contrary to what some commentary might imply, the long-run impact of high tariffs is not to lead to higher inflation. There may be a one-off adjustment higher in some prices, but the Fed can be relied upon to make sure that this does not translate into a permanently higher rate of inflation.[4] Likewise, tariffs don't lead to permanently higher unemployment – the Fed won't allow that: they lead to a different *pattern* of employment.

Indeed, the FOMC (Federal Open Market Committee) has been adjusting its monetary policy stance (so far, more its communication about the likely future course of policy), specifically in response to rising concerns about trade disputes. According to the FOMC's quarterly projections, in December of last year, the median FOMC participant was projecting two further rate hikes during 2019. By March, the median FOMC participant was projecting no hikes this year, with six projecting at least one hike and none projecting a rate cut, and by June only one FOMC participant was projecting a rate hike this year and eight were projecting at least one rate cut.

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[4] To complicate macroeconomic matters even further, the imposition of tariffs may cause the dollar foreign exchange rate to move in an offsetting fashion, that is, to appreciate. This would be the case if the real exchange rate, the nominal exchange rate adjusted for inflation differentials with trading partners, remained (relatively) constant, which would tend to be the case if the savings-investment balance was not impacted (much) by the tariffs.