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Tariffs:

Historical Perspective and the Effects on your Investments

By Kevin Chambers

For the last three years, tariffs have been in the news regularly. They are a vital component of the Trump administration's trade strategy. Let's put tariffs into context with some historical perspective about their previous uses and then discuss how these new taxes might affect investment portfolios.

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What's News

A Presidential Salute Caps Celebration for Academy Graduates

Trump Prepares Mexico Tariffs

Trade Fight Muddles Fed Plan

The Economist

North Korea wants to talk
Russian spies and the assassin's creed
Warren Buffett loses his touch
TECHNOLOGY QUARTERLY: The ocean

The threat to world trade

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What's News

Djokovic Captures Wimbledon in Grueling Match

Tariffs Drive Companies Out of China

China Growth Rate Weakens

Boeing Grounding Risks Hitting 2020

Economic Theory and Tariffs

When it comes to international trade and tariffs, there are two economists that all Econ 101 students learn about: Adam Smith and David Ricardo. Both of their works have created the modern conception of how international trade is viewed by economists today. The principle concept to understand when it comes to international trade is 'comparative advantage.'

Comparative Advantage

Comparative advantage is a theory first posited by Ricardo. He argued that countries should focus their resources on the industries and products that they are most efficient at producing. In practice, this

means if each country makes the product in which they are most efficient and trade with each other, everyone will be better off. To make things simple and to illustrate this idea, let's look at just two countries, England and Germany, and only two products, cloth and wheat.

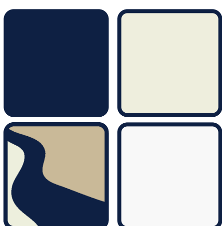
England is very good at producing cloth, but they also need wheat to feed their people. Germany is the opposite. They are very good at producing wheat, but also need to provide cloth to give their people clothes. Let's assume both countries need two units of each product.

Scenario 1

Each unit of wheat produced by Germany costs 1 gold piece. For England to produce one unit of wheat, it costs 3 gold pieces. Same for cloth, but flipped. The cost of one unit of cloth is 3 gold pieces in Germany and 1 gold piece in England. If each country keeps their production in their own economy and does not trade, it would cost them each 8 gold pieces to produce the necessary two units of each product, 6 gold pieces to produce the product they are bad at making and 2 gold pieces for the product they are good at making.

Scenario 2

Now, they decide to take David Ricardo's advice and specialize in the industry they are most efficient at producing, the product that they can produce for the lowest cost. Now Germany makes four units of wheat, costing 4 gold pieces. England makes four units of cloth for 4 gold pieces. They trade. Now each country still has two units of each product, but it costs half as much for them to produce it. Each country is focusing on its comparative advantage.



Ricardo extended this theory to explain that international trade can still benefit a country that might be more efficient than another country at producing everything.

Scenario 3

So same set up, England-Germany, wheat-cloth. But this time the costs of production are different. This time, England can produce wheat for 3 gold and cloth for 1 gold. Germany can produce wheat at 4 gold and cloth at 5. If England produced everything by itself, it would cost 8 gold, 6 for the wheat and 2 for the cloth. For Germany, it costs 18 gold. If they trade, England would have a cost of only 4 gold for the four units of cloth and Germany would have a cost of 16 gold for the four units of wheat.

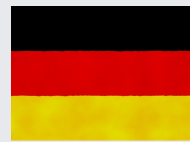
Scenario 4

They trade. Even though England is more efficient than Germany at producing both products, both countries are still better off when they focus on the industry in which they are most efficient. England has an absolute advantage at producing products, but by focusing on their comparative advantage, producing cloth, they can still benefit.

Although this is an abstract example, and based in early industrial Europe, the theory can be projected into our current economic environment. For decades, China has competed on the global stage with its comparative advantage in labor. They have a massive labor force which has worked with low wages. They can produce more and cheaper products than we can in the US with our workforce. However, with our fertile land and mastery of agricultural technology, we have an advantage producing soybeans. China also has fertile land and workers to work it, but it makes more sense for

COMPARATIVE ADVANTAGE

When countries have off-setting efficiencies



Scenario 1

NO TRADING

8 VS. 8

Scenario 2

TRADING

4 VS. 4

COMPARATIVE ADVANTAGE

When one country is more efficient in both industries

Scenario 3

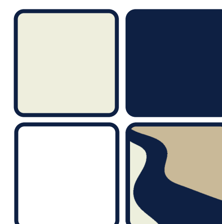
NO TRADING

8 VS. 18

Scenario 4

TRADING

4 VS. 16



them to focus on manufacturing where they have the biggest advantage, and for us to grow soybeans and then trade.

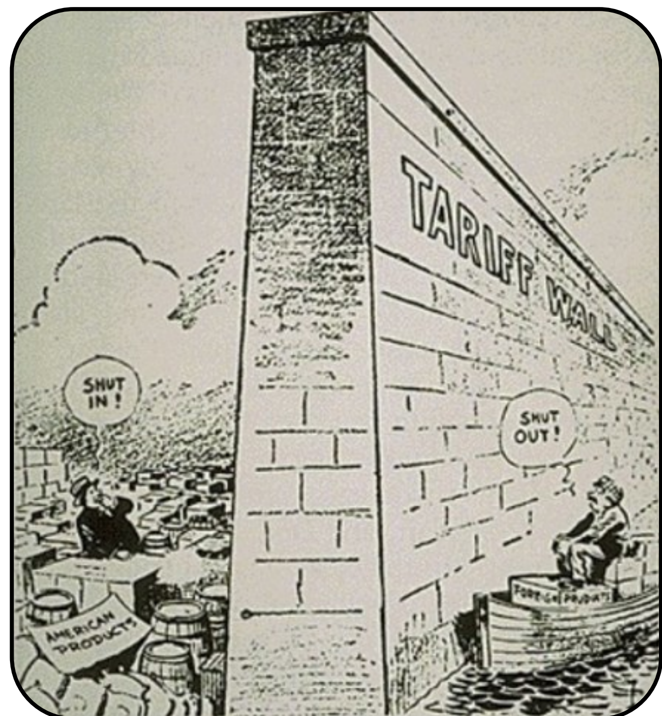
When economic and politics collide

Economists like to imagine a world where everyone is rational and agreeable. A world where maximizing efficiency is everyone's goal. All their models assume that people will follow clean rules of action. However, we know that in the real world, this rarely happens. Human beings are seldom completely economically rational. Adam Smith and David Ricardo dreamed of a world free of tariffs, where goods could flow easily across international borders, maximizing efficiency.

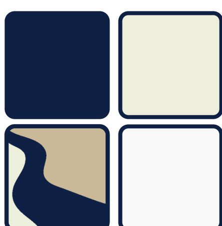
However, politics has a pesky way of entering the equation. Why have governments introduced tariffs in 2019? There are a lot of reasons: to protect the development or sustainability of domestic industry, as a political tool against an adversary, to alter the balance of trade between two countries, or for national security or environmental reasons. Historically, tariffs acted as the income vehicle for governments.

Brief History of Tariffs in the US

In the early years of the United States, Congress passed tariffs close to 15%. Around 1812, when the eponymous war demanded an increase in federal government revenue, tariff rates began to increase. Tariffs spiked in the lead up to the Civil War to over 60% (Irwin, 2006). This was, in part, to support new westward expansion and development of northern industry. Southern politicians argued for lower tariffs since their industry, cotton, was heavily reliant on international trade. At the time, the South produced 70% of the country's exports and generated 80% of the world's cotton. They used this economic power to negotiate against the northern and western politicians successfully. Tariffs dropped sharply back to early 1800s levels in 1857. Up to this point, tariffs were the primary source of revenue raised by the young US government. To make up the lost revenue, the first income tax was introduced in 1861. Although the tariff issue was resolved pre-war, it remained a sore subject for Southerners leading to the Civil War (Loewen, 2011).



Cartoon depicting how the Fordney McCumber Tariff, passed by Congress in 1922 to raised tariffs to protect American manufacturers, also hindered US exports from reaching foreign markets.



Post-Civil War tariffs were enacted on some of the US's 'infant industries.' Since products from these industries were predominantly imported into the US, the government used tariffs to artificially raise the price of these goods, which ultimately allowed US producers to establish their businesses to be better able to compete with foreign alternatives. For example, the US steel industry, specifically tinplate products, were given favorable tariffs. In about a decade, US producers were producing the product cheaper than international competitors and the US became a net exporter of steel and tin products (Irwin, 2000). However, there is still some debate about whether the higher prices charged to other industries reliant on these products were hindered. This debate brings into question the overall success of the economy during this time because of these tariffs (Irwin, 2006). Today, this trade-off is still argued when implementing tariffs: Will the pain of higher prices be worth protecting a particular industry or goods?

Probably the most notorious tariff ever passed in the United States was the Smoot-Hawley Tariff Act of 1930. Many parallels can be drawn between the state of economies in 1930 and in 2019. Slow-growth around the world. The onset of the Great Depression was increasing nationalism around the world. The Nazi party was growing in Germany and in the United States. Congressman Smoot from Oregon and Senator Hawley from Utah spearheaded the legislation that raised taxes in nearly 900 products. Coupled with other fiscal and monetary policy of the era, Smoot-Hawley was an aggravator that made the Great Depression even worse. Countries around the world raised their own tariffs in response. This cycle led to a downward spiral of international trade and a spreading of economic woes around the globe. In 1929, world trade was at $5.3 billion annually. By 1933, it was only $1.8 billion (Economist, 2008).

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HOOVER SIGNS TARIFF BILL AS BORAH IN SENATE SEEKS CUTS BY FLEXIBLE CLAUSE

NEW DUTIES GO INTO EFFECT

The President's Action Made Hawley-Smoot Bill Law at Midnight.

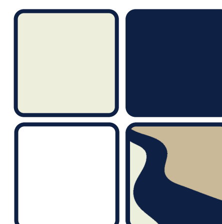
Belgian Government Protests To Washington on the Tariff

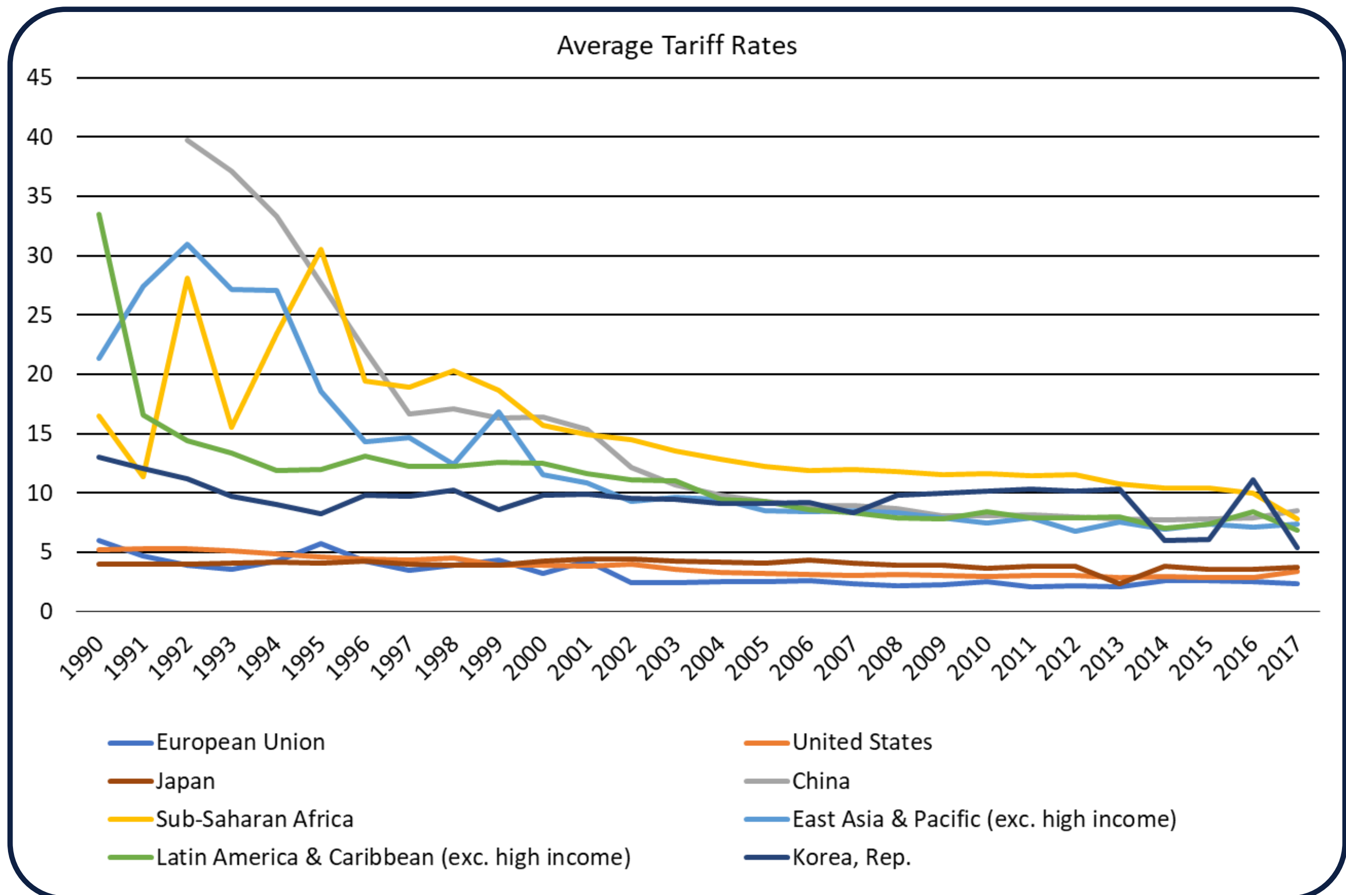
Special Cable to THE NEW YORK TIMES.
BRUSSELS, June 17.—The Belgian Government, through Prince de Ligne, its Ambassador at Washington, has sent the United States Government a note protesting against the new tariff.
The note points out that the trade balance between the two

Post-World War II, the US-led the creation of the General Agreement on Tariffs and Trade (GATT), which later led to the World Trade Organization (WTO) and ushered in policy of trying to reduce tariffs around the world. By joining the WTO, member countries agreed to certain restrictions on tariffs. This shift in views of tariffs led to more massive trade deals and organizations trying to make it easier and cheaper for goods to flow around the world. The European Union, NAFTA, and ASEAN are all an extension of the GATT and a reaction to the negative effect's tariffs had on the pre-World War II world.

Tariffs Today

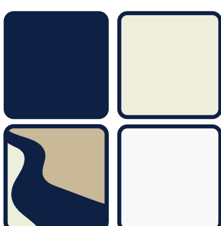
With a few exceptions, free-trade has been the dominating dogma in international trade since the end of World War II. Growing in tandem, and partially as a result, globalization has ushered in a period of unprecedented trade across borders. Tariff rates have remained historically low. In general, developing countries, those still trying to grow, have higher average tariffs, but even these tariffs have fallen substantially over the last three decades.





Source: World Bank

Starting in 1990, most developed, high-income nations already had relatively low tariffs. The US, Japan, and Europe had tariffs mostly below 5% of average. In the early 90s, most emerging-market countries in Latin America, South East Asia, and Africa had tariffs well into the double digits. China's tariffs were often between 30-40%. All these regions have seen a significant decrease in tariffs. The lion share of the decrease in international taxes was in the developing world.



One of the main reasons this decrease has occurred is international pressure from high-income countries. The World Bank and the International Monetary Fund (IMF) put many tariff restrictions on the aid they offer developing countries (Chang, 2008). The primary form of assistance to nations from these organizations come in the form of loans. Many times, the loans came with liberalization requirements or stipulations that the countries commit to freer trade practices (Brown, 2009).

Another reason developing countries have seen a precipitous drop in tariff rates is the increase in numbers of international agreements. Significant swaths of the globe are covered by some version of a regional free-trade agreement. The most

Free Trade Agreements

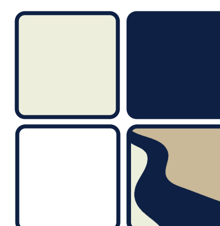
Acronym	Name	Year	Founding Countries
NAFTA	North American Free Trade Agreement	1994	United States, Mexico, and Canada
ASEAN	Association of Southeast Asian Nations	1993	Brunei, Indonesia, Malaysia, Philippines, Singapore, and Thailand
COMESA	Common Market for Eastern and Southern Africa	2000	Djibouti, Egypt, Kenya, Madagascar, Malawi, Mauritius, Sudan, Zambia, and Zimbabwe
EU	European Union	1993	Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands
GAFTA	Greater Arab Free Trade Area	1997	Bahrain, Egypt, Iraq, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, and the United Arab Emirates
CISFTA	Commonwealth of Independent States Free Trade Area	2011	Russia, Ukraine, Belarus, Uzbekistan, Moldova, Armenia, Kyrgyzstan, Kazakhstan, and Tajikistan

integrated and famous agreement being the European Union, but it spans the globe. Free-trade agreements, mostly established in the 1990s, cover most of Africa, Asia, and Latin America (World Bank, 2018).

Free Trade Zones

Finally, the last major mechanism for lowering average tariffs are Free Trade Zones, also called Free Ports or Special Economic Zones. Free Trade Zones have been set up around the world as designated areas that allow companies to set up factories or ports which can ship and produce goods free of taxes. Probably the most famous area is the Chinese fishing village of Shenzhen. A small hamlet of a few thousand people turned in to a massive city of 14 million people in just 30 years. The reason for growth? The Chinese government designated the city as its first Special Economic Zone (Farole & Akinci, 2011). Shenzhen is located just across the border from Hong Kong. Many of the products we know and love have been manufactured in the SEZ. As 'China's Silicon Valley,' Shenzhen is the center of electronics manufacturing in China (Huifeng, 2015).

Special Economic Zones give host countries more control. They get to have a say in which companies are established and the level of tax breaks given to the companies. These zones are managed by either the government, an affiliated private company, or non-profit trade organization. They can also be targeted at a specific industry or a range of sectors. SEZs can be

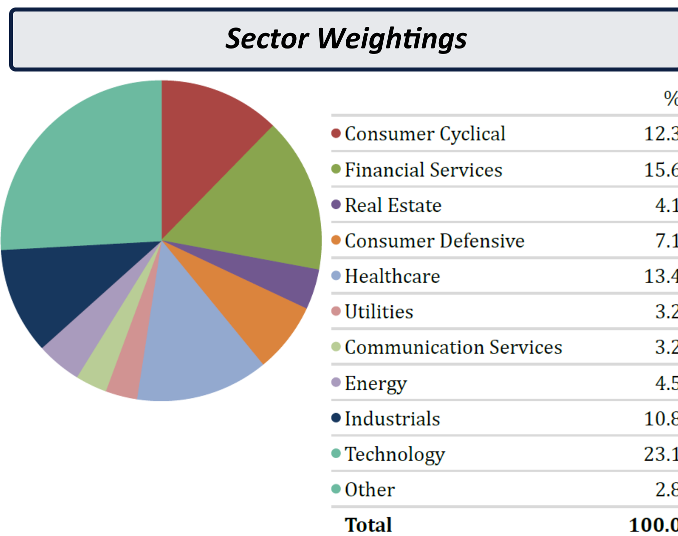


a better fit for many countries than broad trade agreements. They can use the SEZs to better meet their own domestic political needs and international relations goals. It also encourages foreign companies to increase their investment in their facilities abroad.

There are some downsides to SEZs. The growth is often very rapid and concentrated into a small geographical area. Swift, intensive growth can cause an undue burden on the local economy and environment. SEZs can also create environments were workers are overworked, due to growth pressures as zones are established (Slifer, 2007). However, the World Bank reports that working conditions and wages are better in SEZs over-time on average. The success of an SEZ relies on good governance by either the governments or private parties involved (FIAS, 2008).

New Tariffs in Portfolios

It's important to remember that the concept of all tariffs maintains that short term pain is worth the long term potential gain. The Trump administration believes that enacting tariffs against China will help them reach their economic or political goals. But, there will be pain. Industries such as plastics producers, pharmaceutical, agriculture, and manufacturing companies are getting hit the hardest by the trade war (Rabouin, 2019). The higher cost of inputs and components, as well as decreased projections of sales due to China's retaliatory tariffs, can hurt a company's bottom line. The

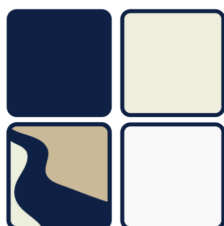


Source: Morningstar

Economist measured a 1% drop in capital investment in the last four quarters from 22 sectors particularly sensitive to the tariffs (Economist, 2019).

The Vanguard Total Stock Market Fund has 3,609 companies in its holdings. The sectors impacted the deepest include industrials, healthcare, and some technology companies. The share of companies that will be negatively affected, in terms of market capitalization, is small but not insignificant. The more significant risk is the possibility that the tariffs push the US economy into a recession. If that happens, it could spread beyond sectors directly connected with China.

Fear of recession spurred on by the continuing trade war has caused the recent volatility and small dips in the stock market. As always, our portfolios are built to deal with these scenarios. So far, we have seen investors run to safety during stock market drops. They have purchased US bonds. Ultimately, the news about increased tariffs is another reminder of the importance of portfolio diversification.



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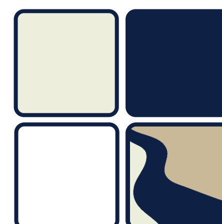

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