The Macroeconomics of Trade War

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The Insteel Wire Products facility in Houston. The business would be affected by a tariff on imported steel. Todd Spoth for The New York Times

Will Trump back down from his urge to start a trade war? Nobody knows; the thing is, he's been an ignorant trade hawk for decades, he's feeling beleaguered on many fronts, and word is that his doctor has told him to eat fewer burgers. So there's surely a lot of pent-up rage that he's all too likely to take out on the world trading system, especially when he tweets stuff like this:

> The United States has an $800 Billion Dollar Yearly Trade Deficit because of our "very stupid" trade deals and policies. Our jobs and wealth are being given to other countries that have taken advantage of us for years. They laugh at what fools our leaders have been. No more!
>
> — Donald J. Trump (@realDonaldTrump) March 3, 2018

So it's worth asking what would happen if Trump really did try to close the trade gap – it's actually $500 billion, not $800 billion, but who's counting – by imposing tariffs.

The trade gap is currently running a bit shy of 3 percent of GDP, while imports are 15 percent of GDP:

If the price elasticity of import demand is around 1, which is a typical estimate for the short-to-medium run, a 20 percent across the board tariff might, other things equal, be enough to close the gap. But other things would very much not be equal.

Leave aside the issue of foreign retaliation/emulation, although that would be a very big deal in practice. Assume instead that the U.S. gets away with it, with no foreign response. Even so, this wouldn't work out the way Trump imagines.

You see, diverting demand equal to 3 percent of GDP from foreign to domestic products would *not* increase US output by 3 percent relative to what it would have been otherwise, let alone the 4.5 percent you'd expect if there's a multiplier effect. Why? Because the US is close to full employment. Maybe – maybe – we have another half-point of unemployment to go. But a 3 percent rise in output relative to trend would reduce unemployment about 3 times that much, 1.5 percentage points. And that just isn't going to happen.

What would happen instead is that the Fed would raise rates sharply to head off inflationary pressures (especially because a 20 percent tariff would directly raise prices by something like 3 percent.) The rise in interest rates would have two big effects. First, it would squeeze interest-sensitive sectors: Trump's friends in real estate would become very, very unhappy, as would anyone who is highly leveraged (hello, Jared.)

Second, it would drive up the dollar, inflicting severe harm on U.S. export sectors. Greetings, farmers of Iowa!

So protectionism wouldn't do very much to reduce the trade deficit, even if other countries didn't retaliate, and would inflict a lot of pain across the economy. And that's without getting into the dislocations caused by disruption of supply chains.

Add in the fact that other countries *would* retaliate – they're already drawing up their target lists – and the fact that we'd be alienating key allies, and you have a truly terrible, dumb policy idea. Which makes it quite likely, as I see it, that Trump will indeed follow through.