Leadership, laughter and tariffs

By Paul Krugman
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There are so many issues breaking right now that it's hard to keep track — and focusing on any one leads to feelings of guilt about neglecting the others. But it's worth remembering that the Trump trade war still seems to be on track, and important to have a sense of its effects.

The view within the Trump administration is, of course, that "trade wars are good, and easy to win." Where does this view come from? Actually, it involves two propositions.

First, it takes the mercantilist view under which trade as a zero-sum game in which whoever sells more wins. Because the U.S. runs a trade deficit, we're losers, and anything that reduces that trade deficit is good.

Second, it takes for granted the proposition that precisely because the U.S. exports less to other countries than we buy in return, a trade war will hurt them more than it hurts us, reducing U.S. imports more than it reduces U.S. exports.

Now, anyone who looks at the actual effects of international trade knows that the first proposition is wrong: trade isn't just about selling stuff, it's about getting better, cheaper stuff both to consume and to use as inputs in production. But you might assume that at least the second proposition is true: a round of tariff retaliation should reduce foreign exports to the U.S. more than it reduces U.S. exports to the rest of the world, simply because those foreign exports are bigger to start with.

But maybe not. A new study from the European Central Bank suggests that even though the U.S. runs trade deficits, a trade war would reduce demand for U.S. goods more than it would reduce demand in the rest of the world. The Bank of England has reached a similar conclusion.

Let's be clear: these are the results of models, not actual experience, and could be wrong. But it's still worth asking why the modelers are getting this result. The short answer is the phenomenon known in the field as "trade diversion."

For simplicity, think of the world as three economies: America, China, and Europe. Both the ECB and the BOE are assuming scenarios in which America raises tariffs on China and Europe, with China and Europe retaliating. But China and Europe don't raise tariffs on each other.

Such a scenario gives both foreign consumers and foreign producers a lot of options to diversify away from America. Chinese producers, facing U.S. tariffs, can sell more to Europe instead; Chinese consumers, instead of paying tariffs on goods imported from America, can seek substitutes from Europe. The story for Europe is the same. But U.S. consumers and businesses won't have comparable flexibility.

The difference in ability to switch partners means that both U.S. exports and U.S. businesses that depend on imported components etc. will be hit harder for any given level of tariffs than their counterparts abroad.

But why assume that it's a unilateral U.S. trade war against everyone? Because that's what is happening. The Trump administration has isolated America on many fronts, and trade policy is very much one of them. Under different leadership, America and Europe might be working together to put pressure on China over things like intellectual property, but given who's actually in charge, we're on our own.

As Trump just found out at the U.N., the world is literally laughing at us. And it certainly doesn't trust us, in fact is looking for ways to cut us out of various loops. This matters for a lot of things — and trade war, it turns out, is one area where go-it-alone will be costly.