WEEKLY ECONOMIC COMMENTARY

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Global Economic Research
50 South La Salle Street
Chicago, Illinois 60603
northerntrust.com

Carl R. Tannenbaum
Chief Economist
312-557-8820
ct92@ntrs.com

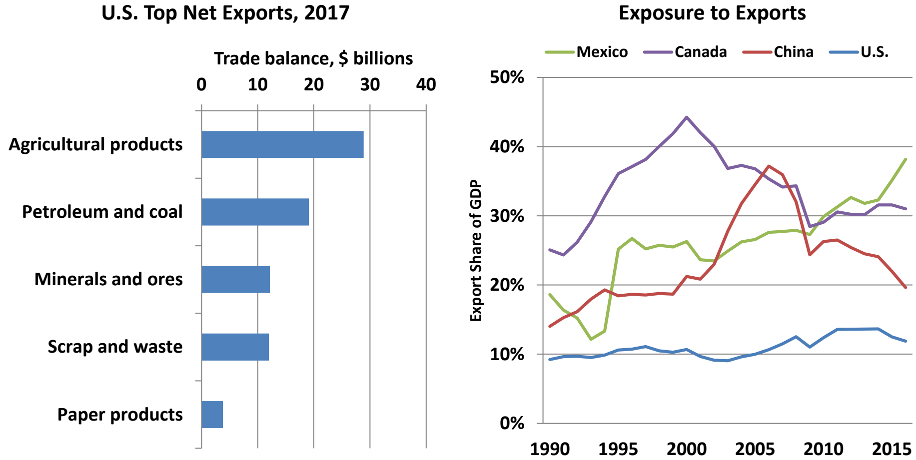
Ryan James Boyle
Senior Economist
312-444-3843
rjb13@ntrs.com

Vaibhav Tandon
Associate Economist
630-276-2498
vt141@ntrs.com

The White House has announced a new set of broad tariffs on steel and aluminum imports. The measure is surprising in its scope, its targets and its break from the long-prevailing trends of international trade. Effects of this announcement could extend well beyond economics.

The tariffs will take the form of a 25% tax on imported steel and 10% on aluminum. They are being justified on the basis that the U.S. metals industry is critical to national security. Section 232 of the Trade Expansion Act allows the President to act in this manner; it was last used in 1986 to protect machine tooling manufacturers.

But this rationale can be questioned. The majority of steel consumed in the U.S. is produced domestically, and most foreign sources are our close allies. Domestic production accounts for about two thirds of U.S. steel consumption, and Canada is our biggest external supplier. So the risk to national security is unclear.



Sources: U.S. Census Bureau, World Bank

The first effect of the proposed tariffs will be an increase to steel and aluminum prices. These hikes will flow to the manufacturers that use metal, who will pass them on to their buyers. Mills and manufacturing are high-capital, low-margin businesses, with little capacity to absorb an increased variable cost. Officials interviewed on the topic frame the added costs as trivial, from less than a penny on a can of soup to a few hundred dollars on a new car. But they do not deny that the tariffs will add to inflation.

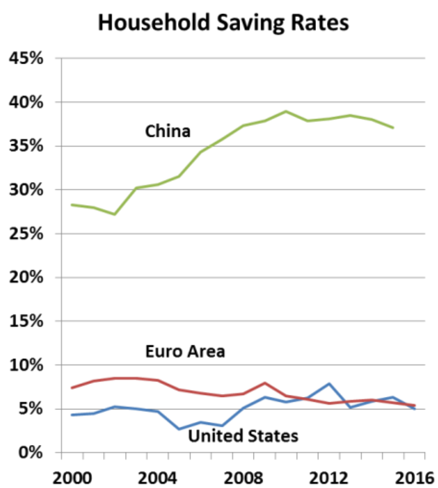
The pressure on prices could increase if our trading partners implement retaliatory tariffs. The European Union reacted within a day with a headline-grabbing threat to tax imports of motorcycles, bourbon whiskey and blue jeans. The next week, the European Commission circulated a four-page draft list of product categories that would be taxed, including a wide range of raw materials, clothing and agricultural output. While we believe an escalating "trade war" is unlikely, it has become more real than it was just two weeks ago.

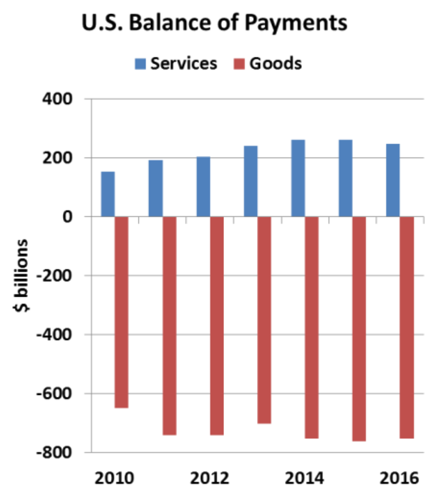
Trading partners closest to the United States stood to suffer the most from the proposed tariff. Their exports to more distant parts of the world would be less competitive due to higher transportation costs. The conciliatory exemption of these countries' metals imports is a rational revision to the proposal. However, the exemptions are only temporary and tied to a renegotiation of the North American Free Trade Agreement (NAFTA). Making the exemption permanent may require concessions from Canada and Mexico.

Tariffs are an about-face from a uniformly pro-business agenda.

More broadly, this proposal is a break from the market-friendly actions taken by President Donald Trump in his first year in office. Thus far, the administration's actions have been pro-business and pro-growth. Deregulation reduces businesses' costs, while tax reductions improve the bottom lines of employers and employees alike. Tariffs will not have a broadly positive outcome. Resistance from business groups outside the metals industry has been swift and vocal. This week's resignation of Gary Cohn as Director of the National Economic Council was testament to the disfavor that classical free trade theory has found in today's White House.

The tariff may not bring substantial benefit to those it is intended to support. Trump envisions a revival in the blue-collar manufacturing economy, restoring jobs that were sidelined long ago. This may happen in some cases, but many steel mills have outdated equipment in poor working order; new mills will require new equipment and employ fewer people (with higher skill levels). The increased costs of metals will affect all consumers; there will be relatively few new jobs created.





Sources: OECD, U.S. Bureau of Economic Analysis

The Trump campaign often took a tone of grievance. Trade deficits were cited as evidence that the United States was "losing" due to a series of "bad deals." This characterization reflects a fundamental misreading of trade deficits and their drivers. The United States has a very low savings rate relative to most countries, especially our primary trading partners. This will inevitably lead to a flow of goods in our direction.

The availability of foreign products benefits U.S. consumers. It expands selection, holds down costs and forces American industries to stay sharp. Further, the U.S. trade gap is primarily driven by trade in goods. U.S. trade in services remains competitive; we export considerable amounts of financial services, information services, transportation and communications.

At its broadest, the tariff proposal is a step away from a global order established in the wake of World War II. Today's economy is characterized by global supply chains, free trade agreements, low or no tariffs, higher quality of life and above all: peace. The Cold War stayed cold, and the conflicts that have arisen have been confined to limited geographic areas. Though countries will always have their differences, they find it best to not attack their customers and creditors.

Bilateral trade figures do not tell the full story of foreign relations.

Trade relationships must be considered in the broad context of international diplomacy. For instance, while China has gained from exporting heavily while keeping its market closed to imports, it will also play a crucial diplomatic role if peace between the Koreas is to be found. Is a level field in certain trade sectors worth the risk of losing the partnership of a growing global power?

The final details of the tariff plan were less severe than initial rumors portended, with President Trump emphasizing its flexibility in his remarks at the signing ceremony. Whatever its mitigations may be, the announcement alone has had a jarring impact on markets and foreign relations. We anticipate this is merely a first act in a broader protectionist trend, a worrying development for the U.S. economy and for the modern world order as we know it.

Look Beyond the External Forces

Emerging markets (EMs) have a lot at stake as global trade policy evolves. Many developing economies are heavily dependent on exports (i.e., demand from advanced economies) as the key engine of growth. Fortunately, the ongoing trends from the major EMs show that domestic demand is becoming a more substantial component of growth than is often realized.

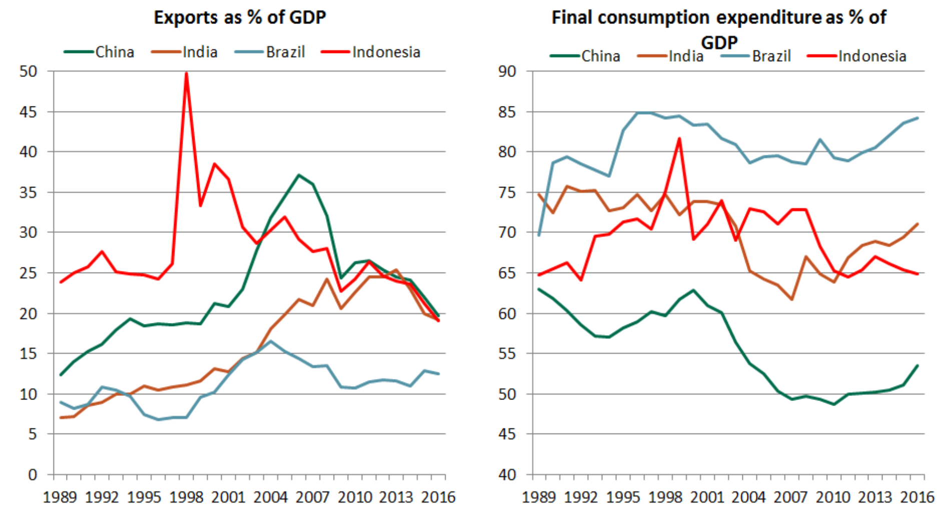
Among most major EM economies, the share of exports in gross domestic product (GDP) has trended lower or flattened out, while that of consumption is on the rise. This is especially true for the emerging Asian markets. For example, exports currently account for around 20% of GDP each in China and India, as compared to 32% and 24% in 2008, respectively. Over the same period, the share of final consumption expenditures has risen from 50% to 53% in China and from 67% to 71% in India. Outside emerging Asia, the share of exports, even in a commodity export-oriented economy like Brazil, has been relatively flat.

Though this decline in share of exports in many EMs can partly be attributed to lackluster global trade owing to weaker demand from advanced economies and rising protectionism, it also supports the common notion that EMs often begin their economic modernization with export-led models. EMs are known to provide support and protection to their domestic industries with an objective of creating wealth to let internal consumption grow to a point that creates better economic balance.

EMs have traditionally had higher saving rates than their advanced counterparts, with the gross national savings accounting for 32% of GDP in EMs compared to 22% in advanced economies. This is also a reason why many EMs have big trade surpluses. Underdeveloped systems for private health insurance and retirement lead households in EMs to save more than their advanced counterparts.

Among the major EMs, China has the highest share of gross household savings at around 37% of GDP, compared to the United States, with a rate of 5%. Although still high, the share of savings in the major EMs such as China and India has been trending lower since 2008. This shift from export to higher consumption and lower savings rates reflects the role of policies pursued by various EM governments to bring balance to saving and consumption.

These policies tend to either build a stronger social insurance system, which reduces the need for precautionary savings and thereby boosts consumption, or expand urbanization or lower import tariffs on high-demand goods. As an example, China, in addition to social security, announced comprehensive health coverage in 2009 to tackle the dual challenge of providing a social safety net and lowering its savings rate.



Source: World Bank

Export-oriented growth is no longer the hallmark for EMs.

Though the share of exports in EMs is likely to recover amid strong global trade growth, it is unlikely to reach close to its recent or previous highs. Domestic demand will continue to be an increasingly important driver of growth. This in turn could lower current account balances if imports outgrow exports, as seen in China and other EMs between 2008 and 2017.

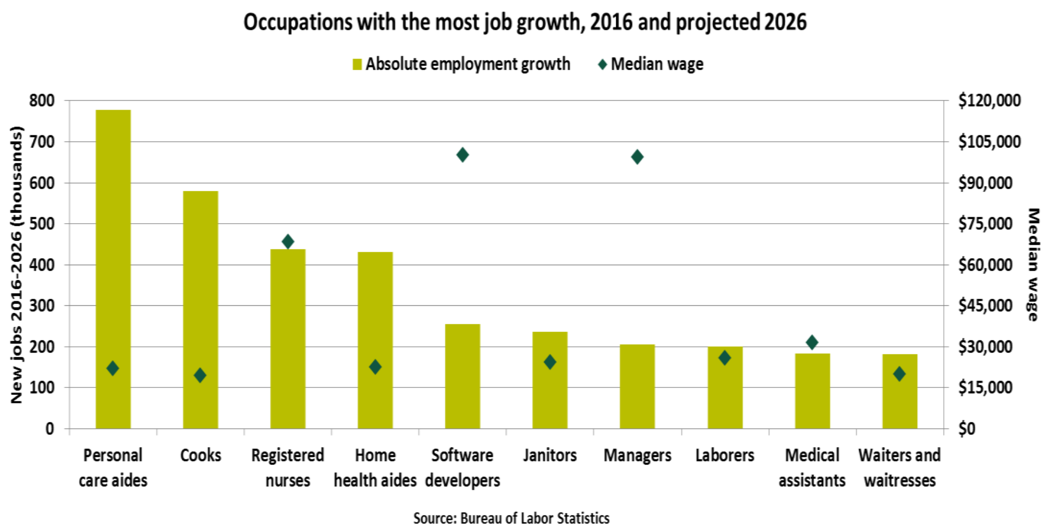
Given the heightened trade anxieties resulting from the tariff announcement by the United States, EM governments should continue to focus on increasing the share of domestic demand in GDP. This shift in the composition of growth should be more sustainable, and attract less unwanted attention from trade skeptics.

What Do You Want to Be When You Grow Up?

The February U.S. employment report was eye-popping, with more than 300,000 new positions created last month. Unemployment remains very low. On the surface, the performance of the American labor market is stellar.

But beneath the surface, some cause for concern remains. The U.S. Bureau of Labor Statistics (BLS) recently refreshed its annual projection of job growth by sector, and its results are mixed.

First, the good news: The labor market is expected to continue expanding, so jobs will be plentiful. But the composition of those jobs may give pause. Personal care aides, registered nurses and home health aides claim three of the top five employment gains in the decade ahead, together representing over 1.6 million forecasted new jobs. The BLS further predicts strong growth in food preparation, cleaning and material moving labor.



Though the quantity of job growth is healthy, the quality of these jobs may not be.

The chart above encapsulates a worrying trend about the U.S. labor market. Seven of the top ten sectors for employment growth pay median wages of $32,000 or less. The poverty threshold for a family of four is approximately $25,000. While a broad mix of jobs is important for the functioning of the economy, the jobs on offer may perpetuate a class of working poor.

Much of the forecasted growth in the labor market is in sectors that do not require a college degree. This may create an inverse skills mismatch: there is a possibility that we'll have a surplus of baccalaureates relative to job openings that require it. In the context of rising costs of higher education and increasing levels of student debt, we have begun an important dialogue about the value of a college education.

Some of the more basic positions have traditionally been taken by immigrants. But current policy is seeking to limit immigration and reduce the number of undocumented workers in the United States.

This is not to say that we should encourage our kids to curtail their educations: students who align their studies with long-term labor demand will be best positioned for success. But if the BLS is correct, the bifurcation of the labor market and of American society more generally may increase in the decade ahead.

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@NT_CTannenbaum