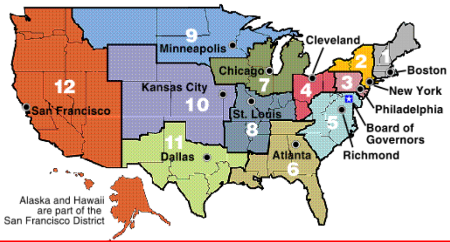

FAO-ECONOMICS

Fact and Opinion Economics

INDEPENDENT ECONOMIC OPINION

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Do Economic trends point to a continuing slowdown? Is the Fed DONE?

The Fed: POLICY BY…Opinion

The Fed and its state-dependent policies…
What it means for you

May 11, 2019

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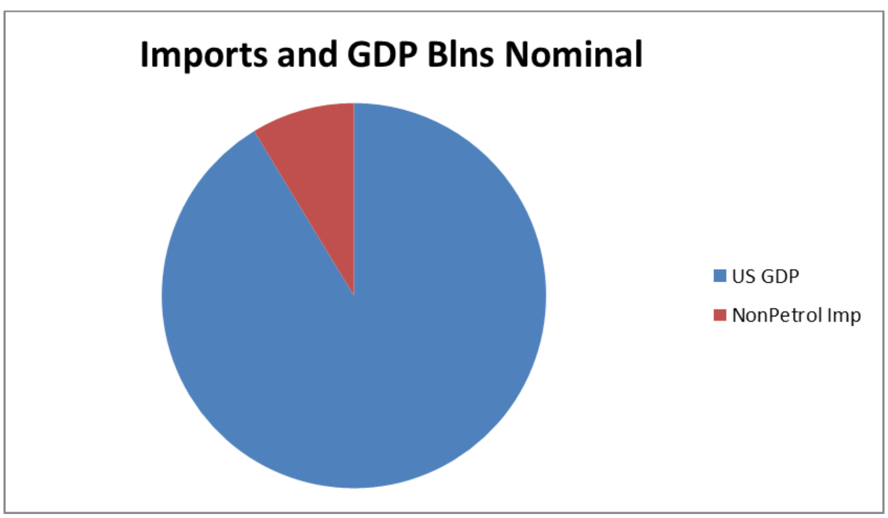
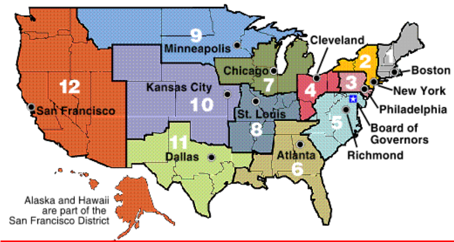
Tariffs and the Fed

We may be about to find something out about the economy. The President plans to impose large tariffs 25% on a broad class of US imports from China this time including consumer goods.

Economist point out that the impact even of 25% tariffs will be small because US imports are not a huge part of the economy and US imports from China as large as they are still will not carry a great inflation risk. Let's look at some numbers.



Total US nonpetroleum imports amount to about 9.5% of nominal GDP



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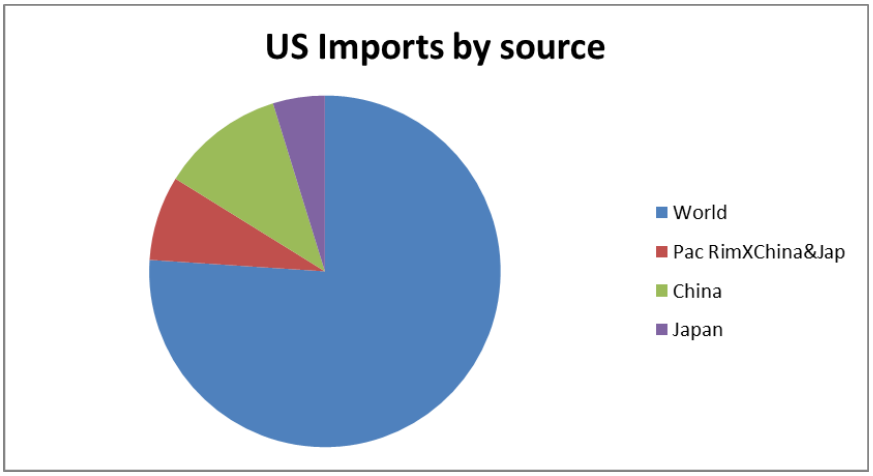


US imports from China are about 15% of total US imports. So if nonpetroleum imports in total are less than 10% of US GDP and Chinese imports are 15% of total US imports, nonpetroleum imports from China will be in the neighborhood of 1.5% of GDP. A simple 1.5% of a 25% tariff has less than a 0.4% impact on prices. And some of these imports already carry 10% tariffs. It is easy to see why total price index pressure of 0.3% or so is being mooted. And that is without any fancy statistics

We can also look at things from a different angle

China Tariff Schematic

Yuan Based Costs ------YYY----> Exchange rate <------$$$---- Importer pays Producer

US Importer ->China ----->>>>> <--$$$--- | V Importer pays tariff to US Government

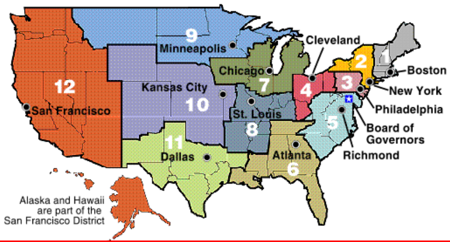
US Consumer or Business pays Importer V V -->>

US Import-Competing Industry Hikes Prices -->>

Price To US Consumer or Business

Core CPI	79.30%	of total	
Goods	**19.5%**	of total	<<-----Tariffs impact here
Services	59.80%	of total	

In additon tariffs wil impact capital goods imports and any intermediate goods imports



The pie charts provide a framework for the direct effects of a China-targeted tariff. But the schematic above provides a bit more insight. China and Asia in general are the (low) marginal cost producing regions for the global economy. By that I mean they have the lowest costs so they set the basic price/cost for many manufactured products. If you begin tinkering with the costs coming out of China you begin tinkering with the lowest prices available and when the lowest costs available go up. There are competitors to think about who might not hold their prices low but might raise their prices as well if a tariff elevates prices from China. So if we consider China as a benchmark price around which other prices are set a different view of is importance might arise.

China processes goods in the yuan currency area. It has yuan costs but will buy many inputs, commodities and oil, whose base prices are dollar prices. Even in their yuan based cost system there is some link back to the dollar area (commodities worldwide are priced in dollars). But based on its use of cheap labor and superior technology China will produce goods for the export market pay shipping and send goods abroad Some 'Chinese made goods' may go to other regions for further processing and that may increase the Chinese content of goods that come into the US from other markets. However, if the market of origin is not China there will be some Chinese content for these goods but no tariffs on them if they are exported to the US.

Once goods that are shipped to the US are bought by importers the importer pays the dollar equivalent yuan price to the importer then pays a 25% tariff to the US government then is free to ship the goods internally or to refabricate, or sell to another business, or to market it to consumers.

Domestic pass through or absorption

The first place where a 25% tariff could be absorbed or lessened to a US consumer would come when a Chinese seller eager to maintain his market would cut his yuan prices to a US importer causing the 25% tariff to be placed on a lower yuan price basis. Next a US importer could cut his margin in selling the good domestically but there is less incentive for a middle man to do that. If the exchange rate were to weaken that too would lower yuan values and reduce the impact of the tariff on the US consumer.

Once US retailers and businesses start experiencing these higher tariff-inclusive prices, there is a secondary effect on inflation. This will come from domestic firms that

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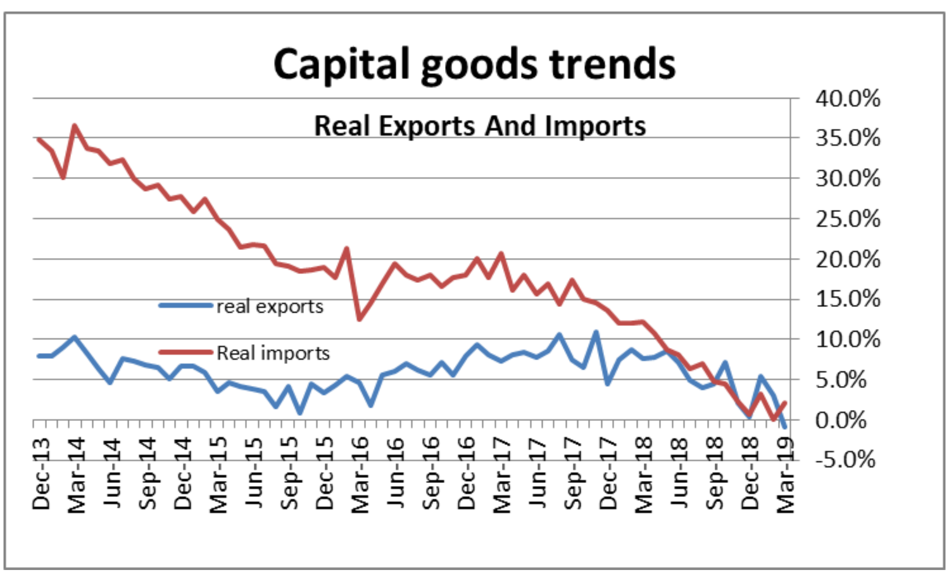
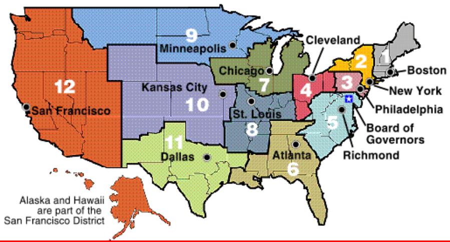
compete with Chinese imports (called import competing industries) but it will also include exporters in other countries whose products compete with China here in the US. Research from the New York Fed (newyorkfed.org) from earlier this year showed that the impact of tariffs on washing machine prices, for machines MADE IN the US saw prices rise quickly and sharply as tariffs pushed up the costs of imports.

This effect puts you on notice that the impact of tariffs on US prices will be larger than just the impact of Chinese import prices on the US price level. As a mentioned above China is a benchmark price and the least cost producer for many goods globally. The potential impact of tariff-distorted import prices on US domestic prices is potentially broader than mere import shares would suggest.

The bottom of the table above shows the shares of goods and services in the core CPI. The core excludes food and energy which seems appropriate since we do not import food or energy from China. Services are produced domestically and economists often refer to them as nontradeable goods. Few services are subject to international competition; none to tariffs. So we are really focusing on the Core CPI for goods. That is just less than 20% of the CPI. We will be looking for the effects of imports raising prices as well as for the Chinese impact on import-competing industries. In the goods core CPI

In addition there are capital goods prices that could be affected...





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Capital goods import trends, however, are fading. Capital goods spending in the US is only about 2.9% of GDP, so there is not a great role for prices to effect inflation through that channel either. The consumer sector in the US in the principle channel,

Broader Economic Impact

US corporations get a large share of their profits from overseas (money.usnews.com). Overall about 44% of S&P 500 firms' sales come from foreign markets (usatoday.com). So an additional risk to US firms' earnings (and a potential for deflationary forces from tariffs) will come if the US–China trade spat slows China enough to produce weaker growth in China with knock on effects to other overseas markets and to US multinationals and other US trade partners.

But…The Domestic Impact Could Be Larger Than What Prices Suggest

Let's not be overly confined in our view about this. If imports from China slow because consumer spending is diverted, and blunted the impact on growth is going to be much greater than the above statistics on the price impact suggest. What is retailing after all? It is an industry that largely sells goods. What is the warehousing, distribution and transportation sector? It is the handing, storage and relocation of goods. If the flow of goods into the US is disrupted or made more expensive it is going to affect all of these so-called service workers too. A lot of service sector workers make a living off of 'goods.' So the overall potential for disruption is greater than the risk of inflation.

The Fed's concerns: prices; measured inflation

Interestingly there is another angle here to observe: the impact on inflation and on monetary policy. The most widely watched consumer price measurement is the CPI. However, the Fed targets the PCE deflator. The CPI is a bit better-known to the public. The CPI is a FIXED WEIGHT basket of goods. That means that every so often the BLS changes the weights and a new price index is formed using fixed weights for the products and services it deems most relevant at that time for the CPI. People always complain that the weights in the CPI do not reflect their individual circumstances.

The index that the Fed targets, however, is the PCE. The PCE uses expenditure weights. That means each month the weights in the PCE index are different depending on the items people choose to buy. With tariffs being implemented the difference between these two indices is of interest. Regardless of how people spend their money the CPI will crank out data based on its fixed weight metric and the price data BLS canvassers turn up. The PCE, however, will use weights based on how people actually are spending their income. So if cell phone and TV prices rise by 25% and if people buy fewer cell phones and TVs then the weights of cell phones and TVs will fall in the PCE and the impact of those price hikes will be less on the PCE than in the CPI where weights are fixed. For this reason I think we should carefully watch the CPI and the PCE in the coming months to see if the difference between these two metrics gets larger. It will be a telling observation on consumer behavior and on inflation whatever the result. It either will suggest that people are avoiding higher-priced tariff-affected imports, or not.

On balance…

Tariffs are not good. Trump is using them as a club to hit China over the head to try to get trade concessions and to get China to trade more fairly. The China-US trade-talks were making progress for a good long time until they weren't. And when progress stopped it did not just stop, China pulled back a number of things it had agreed to. That makes it hard to evaluate where we are in the negotiation process.

For the US having actual trade targets for China and an enforceable deal is just as important as the actual deal it gets. China has been hard to get to keep to its agreements. That is the main reason that the US has taken this much more specific tact on bargaining with China (that China may now resent). In the wake of the talk breakdown we are left to see what happens.

China has been very clever. When it instituted its tariffs it chose its countervailing tariffs on the US it opted for tariffs that would create the most damage for President Donald Trump's supporters in agriculture states. Foreigners are getting very good at attacking not just the US but in getting at it in a way that exploits our political system. China's recent backing off has all the hallmarks of a country thinking it is in the driver's seat. Why? Trump is under pressure. Democrats are pressing him relentlessly over his taxes, to get his staff and former staff to testify before Congress; Congress keeps threatening to impeach him. There is a subpoena for his son to testify. And his Attorney General may be cited for contempt of Congress. The things the Democrats are doing to attack Trump have international consequences; they are undermining the US effort to conduct business and negotiate treaties. US domestic differences are starting to spill over and affect its ability to conduct international business. This is something to keep an eye on as well. It looks to me like Congress has well overstepped its bounds. But that decision is well above my pay-grade. It’s a terrible thing when partisan policies affect the nation’s ability to conduct foreign policy. So who is conspiring with a foreign power to undermine the US now? When is Congress pursing its duties of oversight and when is it pursuing a destructive political vendetta? And who decides that? And is that now part of the China tariff negotiations?

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