Chris Dillow: Why a US trade war may not be a disaster

Our tendency to overweight obvious information at the expense of less salient facts may be exaggerating fears of a trade war

Source: Shutterstock

Thanks to the work of Daniel Kahneman, we know that we are all prone to make countless subtle errors of judgment. One of these is the availability heuristic, a tendency to overweight the importance of obvious information whilst underweighting less salient facts. I fear many are making this error when they take fright at the prospect of a trade war.

Of course, nobody thinks rising tariffs around the world is a good idea. Nor, however, is it necessarily disastrous.

Do higher tariffs really damage trade?

A big clue that this is the case comes from work by Monique Ebell http://journals.sagepub.com/doi/abs/10.1177/002795011623800113 at the NIESR and Silvia Nenci https://ideas.repec.org/p/rtr/wpaper/0110.html at Roma Tre University. They show that cuts in tariffs and free trade deals have only a small effect in stimulating trade, especially in services. It's possible therefore that the opposite is also true - that higher tariffs will do little to depress it.

Companies who have found reliable suppliers will be slow to look for alternatives. And exporters who have spent time and money winning a foothold in overseas markets will want to keep their customers. Higher tariffs, therefore, might well squeeze firms' profit margins but not perhaps do much damage to trade – especially if companies believe they'll be only temporary.

In fact, if you want to know what a big slowdown in world trade looks like, you don't need to consider the possible effects of a trade war. You just need to look at the recent past. The CPB https://www.cpb.nl/en/worldtrademonitor, which provides official Dutch statistics, says that world trade volumes grew by 6.9% per year between 1991 and 2007 but have only grown by 1.8% per year since. And even in the last seven years, they have only grown by 2.6% per year.

These facts tell us that trade growth can fall a lot without any rise in tariffs: these haven't changed much since the 1990s.

2.6% World trade volumes per year

In each of last seven years

Slower trade means slower productivity

There are many reasons https://voxeu.org/article/trade-and-growth-end-era why this has happened. Companies have learned that there are limits to how far they can relocate production to China. Uncertainty about demand and credit conditions have deterred firms from investing in overseas sales networks. Demand in western economies has shifted https://voxeu.org/article/falling-elasticity-global-trade-economic-activity away from high-import areas such as capital goods and toward lower-import sectors such as consumer services. And so on.

Whatever the cause of the slowdown, the effects have been nasty. It's no accident at all that slower growth in world trade has come at the same time as a slowdown in labour productivity growth in western economies. Common sense says the two are linked. Less world trade means less division of labour and hence less specialisation and hence a loss of productivity gains. And it means less competition from overseas and hence less pressure upon firms to become more efficient. Slower trade growth, then, has contributed to stagnant productivity. And stagnant productivity means flat real wages.

World trade, and its determinants, might seem a matter for pointy-headed technocrats. But in fact, it hits every family in the western world in the pocket.

Which raises a paradox. Whilst the threat of a trade war has made headlines, the steady drip-drip of slow world trade growth for years attracted much less attention.

Overrating and underrating

Which is where the availability heuristic comes in. We overrate the importance of policy and underrate the significance of millions of decentralised decisions by companies and consumers around the world.

This is true not just of trade policy but of monetary policy too. Although journalists and some economists obsess about changes in interest rates, the actual impact of these upon output is usually quite small https://ideas.repec.org/p/boe/boeewp/0493.html. Economic growth depends upon much more than monetary policy.

We exaggerate the influence of policymakers – for good or ill – and underestimate the importance of emergence, the fact that our economic fate is determined, unintentionally, by countless people going about their everyday business.

Guest contributors do not necessarily reflect ING House views