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Global Economy Podcast – Episode 111

What Have We Learnt from Trump's Tariff Mess?

Full Transcript

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Fredrik Erixon: Hello everyone and welcome to ECIPE's Global Economy Podcast. My name is Fredrik Erixon and today I am joined by my colleague Erik van der Marel who is Professor of Economics and Chief Economist at ECIPE, and we are going to talk about Trump, tariffs, and the developments that we have seen over the past weeks since April the 2nd when the Trump administration launched its new package of tariff against the world. More precisely, we're going to talk about what have we learned as a result of these tariffs.

So, we're recording this in the morning of April the 14th and I'm saying that because things are changing quite rapidly now so we don't intend this to be a running commentary on what actually has been decided or not been decided. But I think it was a pretty notable admission that arrived over the weekend which is that the United States have now decided to at least partially exempt some specific imports related to technology products from the super high tariffs that they had introduced on China. So, fearful of consequences for instance on access to iPhones or access to different type of input technologies that you need in order to produce different type of outputs in America seems to have forced the administration to at least make a temporary exemption for these types of products.

And I think what this example tells us is that the US economy is deeply plugged into global production networks and global division of labour and unplugging itself from all these types of networks and this form of production is of course going to have drastic consequences on different products that America feels are important.

So, Erik, welcome in the first place to the podcast again and let's start there in sort of the developments that we noticed over the weekend. I think it's a pretty strong symbol of an economy which has changed quite rapidly over the decades the move away from that quite simplistic idea which seems to have guided many in the Trump administration thinking that you can easily introduce tariffs and it's not going to have consequences on the supply or the input of necessary technologies, of necessary goods, or necessary services.

And this of course is something that you have worked quite a lot on over the years and also looked at the overall patterns or change in the economy when countries like America, not just America of course, but when countries like America has changed the profile of its own output and seen sort of more stronger collaborations with companies in other parts of the world that are better at assembling products or that are better at producing different type of inputs while themselves can focus on other type of things.

So, if you start there Erik, is there something you've learned from the, well in the first place, the launch of the tariff package on April the 2nd but also on the consequences for US production and US imports that we have seen since then?

Erik van der Marel: So, thanks for having me in the podcast. Whether I've learned anything from the recent developments I mean a lot of the stuff that is happening follows a certain logic as you said that in my view has been based on theories or notions that I think has increasingly become outdated and that in the minds of the politicians that erect these barriers they have not really understood I think yet how these production structures have changed, and how that does not link up to their sort of notions of how trade policy works.

So, I think as you said I mean one of the major things that have changed is that many decades ago we would produce something at home and we would export it and we would also maybe import a service, an input for the production that takes place at home from A to Z, and that has completely changed over the last sort of four or five decades.

That makes in effect trade policy a lot more complicated, and if you are dealing with something that looks very simple like tariffs, the workout of applying tariffs, because the production structures have become so complicated, doesn't align with what I think these politicians have in mind because if you break up all these production structures across different countries that a you're amplifying tariffs but of anything that you're going to import back into your own country but also things are much more connected between countries than before. So, once you implement the tariffs it touches upon many other nodes if you want, or production stages, of countries that are involved in that big network. So, it makes it a lot more complicated and so I think already what you see I don't think the administration has an easy task of continuing with the tariffs because there is a lot of flip-flopping, and yeah, I'm sceptical about how that will continue in the future with their sort of underlying goal of getting manufacturing back.

Fredrik Erixon: And just to pick one example here so if we take the example of the iPhone. I mean it became also a symbol not just for a new type of market development but also it became a symbol, a decade ago, about or a symbol of how production structures has changed with the iPhone saying on the back of the phone assembled in China. While when you look at the value added in a phone it's actually going to be quite small parts that comes from value added in China value added is going to be much more substantially coming from somewhere else. So, I noticed now that if you look at a company like Apple for instance they have a very strong operating margin they make a lot of money and they generate a lot of value added and the operating margin I noticed was around 30 percent.

And then you look to companies in China that it works very closely with a company like Foxconn for instance who has which has a very small operating margin because they are producing the type of stuff that you don't tend to have very strong margins for value added doesn't tend to be very strong either and the estimate here was an operating margin of three percent for a company like Foxconn.

Now, this of course is a is just one way of thinking about the US economy in the sense that it has changed as a result of all this sort of integration on firm levels with companies and other parts of the world. But, if we flip that around and see so yes all that has happened in goods and it has also had the impact of the US importing more in goods than it's exporting so in plain speak it means that the US trade deficit has increased a lot in goods, but it has also increased a lot in services and I would assume that the flip side of the coin here is that this stronger integration between firms in America and firms in other parts of the world has also allowed the US economy to re-specialise or develop new type of patterns of production which is probably generating a lot more value added than the alternative.

So, if you now think about the US having an attention to repatriate different types of assembly production to America it's going to drain its own economy of resources that are now being applied elsewhere developing much more high value added parts, and I think that's an interesting part to go into because I can't sort of accept the proposition which of course is what you hear from Trump administration officials which is that we can do all this without this reallocation of production having a negative impact on the US economy.

So that begs the question, what is the type of development that US economy have had over the last couple of years? What doesn't mean for its value generation for the way that firms integrate with the rest of the world?

Erik van der Marel: Yeah, I think these are very valid observations and they are aligned with how I see it.

I mean if you have the aim of bringing manufacturing back to a country that has had massive developments in its economic structure over the last three, four decades, along with the spread of global supply chains, I mean it's not going to be an easy task for the reason that you are outlining.

There are two things here that sort of runs through each other what you just said.

So one is the literature in economics, on the spread of global value chains, I mean what we have come to discover is that if you slice up all these different stages it's indeed sort of at the very upstream beginning of the production process that rich countries like the US are specialising in or at the very end of the production process whereas everything that is done in the middle is something that is often outsourced to these low wage sort of emerging markets economies.

Now and that's exactly where this 30 percent comes in so the 30 percent is at the beginning you know when design of the iPhone takes place, or at the very end when the marketing of the iPhone takes place. And these are fundamentally different activities compared to the activities that are in the middle where emerging markets are very good at and where this 30 percent is happening. Is it bad? No because the 30 percent is higher in value added and it has brought massive welfare gains for a country like the US.

So, and that's my second point that's what you also see in countries that develop are getting more richer reaching a higher level of GDP per capita like many OECD countries, and the US in particular, they see that they have moved away from manufacturing jobs so they have not moved away from manufacturing as such but their manufacturing structures have changed a lot, fundamentally changed, so they've become more high-tech, they've become more services orientated, they've become more what one could call intangible orientated, like again doing a lot of R&D doing a lot of marketing for example using a lot of not only digital technologies but also new types of technologies and that makes it yeah that the US economy has really changed. And as a result, I think as you say bringing all that manufacturing activities basically jobs back into a setting that has changed so much is not going to be easy. I believe already unemployment is not that high in the US, if anything is actually quite low, so a you need to recruit people who have a non-college degree in the US which I think given the low unemployment rates is not very easy, and if you were to do it, I mean as you said, you either have to re-source or reallocate the resources out of these higher value-added activities into something like manufacturing, that happened in the US like 30-40 years ago, but that's the main bottleneck in my view. I mean the manufacturing that will go back to the US economy is not the same as three or four decades ago, it's not going to help so much the non-college the lowest skilled manufacturing job for which this is all taking place. So, I'm deeply sceptical here.

Fredrik Erixon: And this is also what we're seeing for instance with plans that America's had to build semiconductor factories. In the CHIPS Act they wanted to attract a lot more investment into producing chips, but they have great difficulties just finding staff and finding the type of labour that is going to be necessary if you want to do that. So that's for sure.

But, if we if we think about it in this way, Erik so we have one part of the economy and let's call it old globalisation and this seems to be the part of the economy that the Trump administration is concerned about is trading goods it's the way companies buy and sell stuff basically. And then we can call the other part new globalisation, which is the other part that you were just talking about, where the 30 operating margins for Apple comes from so it's R&D it's design it's a host of different activities which are high value-added and they tend to be very early in the entire sort of chain of either value creation or supply. And then we have also towards the latter part of the process which is when you start to work with different type of marketing and different type of activities which is about trying to get consumers to buy the products that you have.

So, if we talk about if we if we flip to that new globalisation part, how do you think America stands up in new globalisation? Is it is it a poorly performing economy or a very strongly performing economy?

Erik van der Marel: No, and I think that's the irony of it all, I mean the American economy looks very good if you look at their activities at both ends in the supply chain. So, in terms of economic activity production structures I mean you see that the American economy is doing very well in that regard but also I think in trade it is doing very well in these activities so you know you trade what you produce at least what you produce a lot of and the economy, the US economy is doing very well in that regard so it doesn't have a trade deficit it has a trade surplus in all these kind of modern activities that they export and these are services these are modern services and as you said you need to think about R&D services, you need to think about consultancy services, marketing, all sorts of things that can be supplied over these digital networks that can be connected over digital networks and the American economy is very good at that it has very many good multinationals that are very active in these kind of activities. And so, it is if anything outperforming a lot of these countries yeah in which it tries to target with these tariffs.

So, to me again, it doesn't really make sense and I think that is part of neo-globalisation and usually what I see if I look at the data the US economy is well placed to capitalise on that, and the tragedy is I think, once you are trying to correct things in the old globalisation, the extent to which you can profit and capitalise on what you're good at is going to be compromised and I think that's yeah that's the tragedy behind these policies.

And I think just also in terms of jobs, I think there is a bit of literature as well that if you do tend to specialise in these high value added services, but not only services, also manufacturing and sort of the high tech the high value added manufacturing like semiconductors, like I don't know space if you look at the future, or other sort of very advanced manufacturing like defence, it's not that the non-college low educated workers are not going to profit from it anymore but they are going to profit nonetheless from it but in a different way in a more indirect way. So, it's not necessarily that these low skilled manufacturing jobs are going to be found in the high skilled manufacturing jobs in which the US is good at, but they draw in a lot of supplying goods and services in which you'll see a lot of these non-college low skilled workers. And so, there is an indirect effect, I think, that is also sometimes not very well understood that draws in a lot of these workers that are very concerned about de-industrialisation.

Fredrik Erixon: And when we talk then about US strengths in this form of new globalisation, so I think my question is, what are we talking about?

I mean I had a look at US trade data on the export of services and one thing that is very clear is of course that yes, the US has some strength in what we perhaps in the popular debate would associate with United States services, and that's going to be American big tech (so the likes of Apple of course but a number of other companies as well that are competitive they are innovative and they sell a lot). But, what I noticed in the trade data is that they actually do represent a pretty minor part of US trade and services and that US trade and services is scattered around many different sectors. You have categories that are pretty obvious like financial services for instance, but then you have categories that are a bit more strange or perhaps that may not be obvious to sort of the normal observer what they are about so: R&D services, management services, there are category called business services, which are pretty substantial when you look at US exports of services.

So, what's behind all this? And, why is it these types of services that they trade in? And, how does that trade work? How do you trade in business services?

Erik van der Marel: Yeah that's a good question I think trade and services is still very much misunderstood what it actually entails because as you said there are many services.

So, let me start from there I mean there's a wide variety of services but I think the best way to see it is to see that you have what you could maybe call traditional services and what you call modern business services that you are referring to.

So, the more traditional services are the ones where you see these activities being very much attached to goods production for example. And where it is still somehow required to have either the producer or the consumer moving from one country to another. In other words, they are tradable, but trade costs are still relatively high in these kind of services activities in order to get the commodity traded. And then you need to think about construction services, transportation services, distribution services etc. Tourism is also one.

And then, I think you have the more exciting part which I think belongs to that neo-globalisation that you were referring to. Those are what you can call modern or business services and what's happening there is that the role of digital technologies has sort of played a big and important sort of factor there. So, it's thanks to these kind of digital technologies that these services can be traded a distance from you know one country to over another without having one of the sides of the transaction having to move from one country to another. And these are you know consultancy services, professional services like lawyers that you know help also increasingly being sort of penetrated by digital technologies these activities, architectural services for example, marketing services, design services, and R&D services. So, these are all different types of activities that has become very easy now to trade thanks to these digital technologies where trade costs are actually very low.

Now, how this is traded over these digital networks is still somehow I think a little bit misunderstood. So, one way of doing it is that you can do it just you know like we are doing I mean I'm sitting in Belgium and you are sitting in Sweden and I could provide a service and you buy it over the digital networks and that's it. But a lot of these digital service or modern services are also traded within multinationals, so don't think about a multinational having an affiliate in another country and they are doing a lot of back and forth of these transactions and a lot of that trading goods happens within big multinationals but also in services a lot of it is happening. Now, if you take something like R&D services I mean we do measure you know to some extent what's happening within these multinationals, but maybe not everything, and so in that sense I think what you said US firms, US multinationals in these activities are very good they have you know the trade surplus. I mean they're having strong comparative advantages in these services, but I also think that somehow we are miss or underestimating the extent to which these firms are very successful in trading these activities actually.

So yeah, all to say is that, I think the outlook of the US economy in exporting these activities these services are very good and I think is even you know better than we actually think.

Fredrik Erixon: Yes, so in other words, if I understand you correctly Erik, that exchange is probably bigger than has been estimated or that has been recorded in official data, is that what you're saying?

Erik van der Marel: That's yeah, that's what I'm saying, and that is also what I think.

I mean R&D service is one of them but also for example you know the ideas behind R&D, patents that have been sold, trademarks that have been sold, but also for example if you think of services that are more digital enabled, you know you're referring to big tech, they provide a lot of services that are provided along with the flow of data (cross-border data for example) these are things that are very hard to measure. If you think about a multinational in these modern activities like consultancies what you often see is that they are consisting out of large teams across borders within these multinationals and what they do is collaborating with each other which is also a form of exchange across borders and that is not well understood I think, and under measured if you want. And so I would think that all these sort of different kinds of what I would call new flows or flows of new economic globalisation, they actually make that trade or that globalisation or the comparative advantage of a US economy, in these kind of modern activities, much bigger than actually we think and so I think yeah in that sense the US is well placed in order to capitalise on these modern production structures.

Fredrik Erixon: Very good. I have, I mean, on that note, I mean, I've also seen estimates suggesting that, I mean, if you would have a more fuller, a more rounded, say, way of estimating how much that United States actually exports in modern services, it may actually be so big that it could, at least with some countries, for instance, the EU, it could cancel out the deficit that the United States have for trading goods. So, the proportions, and that's my point here, is that the proportion of it can be actually pretty substantial. So, it's not sort of a small margin of error, it may actually be a pretty big margin of error.

Erik van der Marel: Yeah, no, that's correct. And on top of that, I think many of these trade deficits and trade surplus are measured in gross exports, the traditional way of how we measure trade that sort of crosses borders.

But economists have also come from far to measure the value-added component of trade that is crossing borders. So, if you have a standard good that crosses border many times, you basically are somehow double counting. And so, in order to really find out what the actual value added is that crosses the border, that's actually often a lot lower than actually measured in gross, so the net value added, but the reverse is true for services. So, the value-added component is actually very big.

And so, I have seen the numbers that, you know, what the US exports to the EU sort of balances out what the US is inputting from the European Union, which I think many of these figures are based on gross exports. And I would sort of think that in net terms, that actually would even be bigger.

And so indeed, I mean, it's, it really depends on what you are looking at, and what you are measuring here. And yeah, I think, to say that the US has a trade deficit with the EU, merely on the basis of goods, that omits a lot of activities that are actually happening in the US, and where a lot of other people can also profit from including those that are, you know, for which we think we need to re-industrialise the US economy. I mean, they also profit from that trade surplus that the US has from the EU. And yeah, it's often misunderstood by these politicians.

Fredrik Erixon: And if I may connect that to a thing that has surprised me a bit, and there is perhaps a *mea culpa* that I should add towards the end of what I'm going to say now, but I think it's even fair to say that it has surprised markets more than perhaps people like ourselves that have followed trade and trade policy, trade economics for a while, which is that the market reactions have been very strong to these tariffs. We have seen stocks falling quite substantially. And these stocks have also fallen substantially for companies that are pretty skilled at the modern new type of globalisation that you were talking about. And you can make the point, yeah, but that was because they were overvalued when we started into this particular period with the tariff brouhahas. But the reality is that they have fallen very, very substantially. And it's not just stocks in America that has fallen substantially but also stocks elsewhere that tend to represent a new type of production. I think that's been interesting.

It's also been interesting to see that the macroeconomic effects that a lot of our forecasting are so much bigger than the macroeconomic effects that they forecasted just prior to the April 2nd announcement by the Trump administration to go for the tariffs. I think it's fair to say that the assumption then, even if they perhaps assume that the tariff package was going to be more moderate than it turned out to be. But I think the assumption was basically that America's strong economy, it can weather these tariffs. If it's going to have an effect on the US dollar, it means it's going to appreciate. There are recession risks in the economy, but they tend to be pretty mild.

What we have seen now over the last couple of weeks, over the last 10 days, more specifically, is that all these forecasts have become much, much stronger and gone in a much, much worse direction for the US economy. So, everyone seems to assume that at least one percentage point of economic growth for 2025 has been shaved off. Recession risks have increased quite substantially. The dollar did not at all appreciate, it actually depreciated. So, the value of the dollar, for instance, against the euro has declined quite substantially. Yields on US treasury bonds have gone up, which means America needs to pay a lot more for all the debts. It either needs to take up a year because of fiscal deficits or all the incumbent debt that it needs to roll over as it refinances its liabilities.

And all this, I think, has also woken a lot of people up to the risk that the American economy may actually be about to crash into a wall. That unless you have sort of more competent economic management reasserting itself in the US economy, they may actually be confronted with scenarios which are much more negative than the ones that they have also been talking about now. Recession risks may go up, the dollar can plummet even more, costs for US taxpayers are going to go up, etc.

And I mentioned this, and I alluded to a *mea culpa* that was going to come because when we have done trade economic analysis in the past, we have not really built in these channels, these macroeconomic channels in our analysis. I have ridiculed economic analysis of constructive trade policy, which built in assumption that, for instance, equity premium risks, or equity premiums generally would develop in an advantageous way as a result of trade agreements. And I think along with many other economists, I have thought this to be a very speculative type of benefit that would come from a trade agreement. But now I'm not so sure anymore. I'm watching sort of the uncertainties, the institutional uncertainty that we have now in US trade policy, you see that you're creating macroeconomic events, and you're seeing other channels flowing from changes in trade policy, which are very, very important.

And this is perhaps my takeaway point so far. I mean, we're only about 10-12 days into this trade war now, and things may change. But one of the takeaway points I actually have thought about quite a lot in the past days is that there are substantial risks that you create a macroeconomic event when you start to use trade policy in ways that are unpredictable and looks to be severely damaging to your own economy. And that forces us to think in much broader ways about how trade sits in a pretty central position with a broader macroeconomic performance of a country.

Erik van der Marel: No, I think you're correct here.

So, there are three things that I would like to say. So, first is a more sort of semi-academic remark. And the other two ones, I think, has to do with the tariff itself and how, what we said before, these production structures have changed.

So, first of all, I mean, if you look at the trade literature, and this is maybe sort of my sort of academic side of it, you do see that the macroeconomic literature and the trade literature traditionally has been sort of, you know, it's a separate sort of field strand of the literature. So, it did not be very much integrated, maybe there was no need for it. Also, I mean, trade adds to growth, but you know, there are other factors in the economy, like macroeconomic policy that adds a little bit more to growth, usually for countries than trade. So, I think, you know, there is a reason for that.

Fredrik Erixon: May I just jump in here. What you're basically saying there, Erik, is basically that for a long time, we thought that trade policy wasn't that important, right?

Erik van der Marel: Yeah, so it's difficult to say that out loud. But I think the more you develop as a country, I think the more the marginal benefit to change on traditional trade policies like tariffs, yeah, the less that might add to your economy, not for poorer developing countries. I think that's why I'm always saying trade is really, by and large, a developing sort of tool. But I will get back to this. But I think, yeah, that's true.

The second point is these tariffs are actually quite high, what we are seeing, like, I think, you know, the US-China tariffs, I mean, you know, this is not small beer anymore, this is really, you know, making a wall between countries. And so the effect of tariffs, I mean, are not therefore that small either. And so, these are going to have, you know, bigger impact than, than many of these estimates before may have come up with, because I wonder, you know, the Goldman Sachs and all the other ones that have made all these assessments before whether they were really envisioning tariffs of 145%. I mean, I wonder, I mean, so I think that took everybody by surprise.

But I think a more interesting comment, or thing maybe, that makes it that actually, the reason why smaller tariffs, or the reason why tariff policy as such will have a big impact on the economy nowadays, and even macroeconomic policies, is that what we discussed before. So, the extent to which these production networks are so integrated nowadays across borders, but also across many other activities in the economy, right? So, I mean, yes, you know, an aeroplane like Boeing, for example, has many, many different inputs like the iPhone from abroad, but also from the domestic economy. So, once you're putting up like something like a tariff, which, you know, maybe it's not 145%, but a little bit smaller, that has massive ripple through effects for many other activities. And so obviously, and we call this with like an expensive word in economic, the spillover effects are much bigger than we used to analyse trade policy, like many decades ago. And I think that links up to your first comment about that that has massive implications nowadays for also macroeconomic policies, and the dollar as a consequence. So, and that's interesting, because yeah, so far, I mean, you know, it has been sort of treated as a separate sort of thing, macroeconomics and trade, or, you know, we use microeconomic tools. But because these new economic production structures that apply for new globalisation, and I'm a bit speculative here, I mean, that might change again. Yeah.

Fredrik Erixon: Yeah, no, I think that's a good summary, Erik. And going back to my, not my question, but my proposition to you, which is basically, we have developed a strand of thinking, both, I think, in the general economic discussion, and when it comes to the modelling of different type of consequences of trade agreements. In both these areas, we've developed a way of thinking, which is that trade policy may not be that important.

And as you say, that may be because, unlike the enormously strong hikes in trade, or in tariffs that we now see between the United States and China, that wasn't really what we were thinking about, when we were trying to estimate the economic consequences of trade agreements that are constructive, and that aimed to try to reduce the level of tariff restrictions that exist between countries. But I think it's still the case that what we're seeing in America right now is a good teaching lesson for many, especially for the general debates that sometimes have been flippant about trade and the role that trade plays for prosperity, for macroeconomic stability, but also for trade economies that I think my, my takeaway point is that we need to think much more creatively and much more structurally about what channels that flow from changes in trade policy into the broader economy, as we probably are going to engage with a world where more trade restrictions are more likely than less trade restrictions going forward.

So, perhaps we should end on that note, Erik, which is basically a task for people like you and me, which is that we need to become better at understanding how trade sectors and trade policy in the broader economic framework, and what it actually means when you start to fiddle around with different types of tariffs, or other forms of trade restrictions, that they may have much stronger consequences than you than you imagine, because of the integrated nature of the trade sector into the entire economy.

Erik van der Marel: Yeah, I agree. And there's a lot to explore for people like us for other economists for political economists as well. Yeah, I do agree with that.

Fredrik Erixon: All right, very good. Thank you very much, Erik. It was great talking to this Monday morning.

And thank you also to all of you who have listened, we are most certainly going to return to issues about tariffs, Trump and the United States in the near future. So, tune in in the future as well. Thank you.

Erik van der Marel: Thank you.