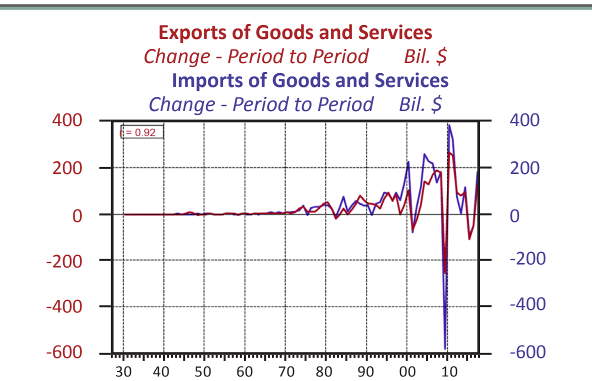
Legacy's Senior Economic and Investment Advisor PAUL L. KASRIEL

One Simple Policy to Simultaneously Strengthen Your Currency and Weaken Your Exports

If a policymaker wanted to simultaneously strengthen the foreign exchange value of a country's currency and weaken the country's exports, that policymaker would be advised to impose tariffs on the country's imports. This is the policy prescription I gleaned from reading Dartmouth College Professor Douglas A. Irwin's 30-page monograph, "Three Simple Principles of Trade Policy". The three principles of trade policy discussed in this intellectually powerful and compact publication are: (1) a tax on imports is a tax on exports, (2) businesses are consumers too, and (3) trade imbalances reflect capital flows. I have previously discussed, albeit in a less eloquent way than Professor Irwin, his third principle in my March 5, 2018 commentary, "The Expected Widening in the U.S. Federal Budget Deficit Has Trade Protectionist Implications". In this commentary, I want to present Professor Irwin's first principle, again less eloquently than he.

CHART 1



Sources: Bureau of Economic Analysis/Haver Analytics

Suppose that the U.S. government imposes tariffs on say, Chinese goods. This will increase the price of those Chinese goods on which tariffs are imposed. The quantity demanded by U.S. residents of these Chinese goods will decrease. This will lessen the demand for Chinese yuan in the foreign-exchange market because fewer Chinese goods are now being purchased by U.S. residents. The fall in the demand for Chinese yuan will cause its foreign-exchange value to depreciate vs. the U.S. dollar. Alternatively, the foreign-exchange value of the U.S. dollar will appreciate, or strengthen, vs. the Chinese yuan. So, one Chinese yuan will now purchase fewer U.S. dollars, making the yuan price of U.S.-produced goods higher. The appreciation of the U.S. dollar will cause the quantity-demanded by Chinese residents of U.S.-produced goods to decrease. So, the net results of the imposition of tariffs by economy'spolicymaker will be to cause that economy's currency to appreciate in the foreign-exchange market and to cause that economy's exports to decrease.

Professor Irwin makes the argument that "[e]xports and imports are inherently interdependent, and any policy that reduces one will also reduce the other." This suggests that an economy's exports and imports should be positively and highly correlated. That is, if exports rise, so should imports. The chart below in which are plotted year-to-year dollar changes in the annual averages of nominal U.S. exports and imports from 1930 through 2017 contains data that are consistent with Professor Irwin's argument. The correlation is positive between the dollar changes in U.S. exports and imports and its value is 0.92 out of a possible 1.00 high.

In sum, if a policymaker's goal is to simultaneously strengthen an economy's currency in the foreign exchange market and decrease the economy's exports, then, by all means, the policymaker should impose tariffs on imported goods. ■

Paul L. Kasriel,
THE ECONTRARIAN

Paul is Legacy's Senior Economic and Investment Advisor and former Senior Vice President and Chief Economist at The Northern Trust Company. Paul works across Legacy's wealth management initiatives, consulting on investment strategies with his innovative research.

Considered one of the best economic forecasters as measured by long term accuracy, Paul is a highly regarded, innovative economic researcher whose work has helped form economic policy at national and global levels.

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