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Trade Protectionism & the Principle of Comparative Advantage

"Reductio ad absurdum": **In logic, *reductio ad absurdum* (Latin for "reduction to absurdity"; or *argumentum ad absurdum*, "argument to absurdity") is a form of argument which attempts either to disprove a statement by showing it inevitably leads to a ridiculous, absurd, or impractical conclusion…**

-Wikipedia-

The rise of nationalism and trade protectionism poses perhaps the most serious threat to the global economic order since the Great Recession of 2008. Countries from the U.K. to the United States to France, to name just a few are increasingly turning to populist and inwardly focused political and economic agendas in a 180 degree pivot away from the forces of globalization that have shaped the last thirty years. This movement is troubling, as we hold the strong view that globalization and the expansion of international trade and the "thinning" of national borders has been tremendously beneficial to global economic growth. Arresting and reversing this trend poses great risks, as historians generally agree that tariffs and protectionism exacerbated the world's economic woes during the 1930s Great Depression. But of course, not everyone shares this view today. Many voters in Western countries feel disenfranchised by globalization, and feel that its economic benefits have accrued disproportionately to the so-called "one percent", failing to trickle down to the population at large, leading to high levels of unemployment and underemployment and a declining standard of living. Accordingly, politicians, most notably in the United States have seized upon this malcontent and now promise to re-shape trading relationships to the advantage of their own citizens. The superficial allure of such a promise is easy to see…the simple narrative essentially is that trade deficits are bad and go hand in hand with jobs being exported overseas and conversely, trade surpluses are good and are synonymous with the repatriation of overseas jobs and the renewal of the domestic economy, manufacturing base, etc.

A basic economic identity is that gross domestic product (GDP) is the sum of the following elements:

GDP = C (Consumption) + I (Investment) + G (Government Spending) + X (Exports) – I (Imports)

So, if economic growth, or increasing GDP is the desired objective, then the appeal of growing exports and curtailing imports is seemingly unassailable. But of course, the reality is more nuanced, and illustrates the old adage that "a little knowledge can be very dangerous". To see why, let's carry out a little thought experiment.

The year is 2020. Three years prior, the United States withdrew from NAFTA and levied a 100% import duty or border tax on Canadian and Mexican goods crossing the border. Naturally Canada and Mexico responded in kind, and trade flows between the three countries fell precipitously. No longer marginalized by the scourge of northbound avocados, tortillas and Coronas or the relentless southbound flow of Quebecois maple syrup, Celine Dion CDs, Ontarian auto parts, Manitoban back bacon and Albertan crude oil, America declared itself great again with trade deficits finally zeroed out vis-à-vis its continental neighbors. A great many jobs were created in previously hollowed out sectors. Yet somehow, still, all was not well. The price of a gallon of gasoline had skyrocketed, given the insatiable appetite for oil and the now 100% higher cost of Canadian crude oil. Imported produce formerly sourced in winter months from Mexico was now being shipped from as far away as Costa Rica and even Brazil, leading both to episodic shortages and ongoing tremendous food price inflation. Border states in both the north and south found themselves with excess capacity and companies were scratching and clawing for overseas export markets for their advanced manufactured goods and consumer products, with the previously vibrant Canadian and Mexican export markets all but closed given these countries retaliatory import taxes on U.S. goods.

Over time the malaise deepened, and regional disparities started to surface, notwithstanding America having ostensibly been made great again, with strong job creation and a huge improvement in the trade deficit. Then, in 2021, a firebrand populist new governor in North Dakota was elected. Tired of the chronic trade deficit his state was running in agricultural products with Florida, he enacted a 100% import duty on Florida oranges, noting that "we have the technology to become agriculturally self-sufficient", and promising impressive job creation in the agricultural sector. In time, greenhouses were built, chemicals, fertilizers and harvesting equipment were sourced, and labor was lured via high wages away from the oil rigs of the Bakken shale fields into this new North Dakotan growth industry. Oranges grew in abundance across the great frozen tundra of North Dakota in January. Yet oddly enough, few North Dakotans seemed much interested in purchasing $14 oranges. Florida, in turn, tired of the ongoing trade deficit in oil it was running with North Dakota levied an import duty on North Dakotan crude oil. Of course, with a population of some 20 million, the state's enormous energy demand soon forced the governor to lobby federal authorities to lift the ban on offshore oil drilling. Shortly thereafter, the Floridian coastline was dotted as far as the eye could see with oil rigs pumping offshore oil. Oddly enough though, the thriving Miami Beach, Naples and Tampa Bay tourist and snowbird economies soon shriveled up to a shadow of their former selves, as vacationers seemed somehow less enamored with the aesthetics of the shoreline now dotted with oil rigs and the occasional oil slick. The Sunshine State's orange growers also found themselves scrambling to find markets for their glut of oranges with North Dakota now fully self-sufficient in orange production. Not be outdone, West Virginia, long weary of feeding those parasitic Wall Streeters and seeking to shore up their trade deficit in financial services invoked an import duty on brokerage and investment management services, promising in the words of their new governor "to spawn a financial hub to rival New York, London or Geneva in our very own backyard, creating thousands upon thousands of high paying jobs". Oddly enough though, five years hence as West Virginians opened their investment statements, they found that former coal miners turned hedge fund managers were surprisingly inept at beating the S&P 500. Brash New Yorkers were, of course, incensed by the West Virginian slight, and vowing to wean themselves off of dirty Appalachian coal, introduced an import duty on West Virginian coal with the promise of supporting the state's fledgling solar panel and clean electricity industry. Oddly enough though, in time, New Yorkers found that the state enjoyed a mere 8 hours of daylight and was quite often under overcast skies in December and January. Thus, thousands upon thousands of acres of solar panels were needed to replace the former coal fired electricity. Hydro prices skyrocketed and blackouts and brownouts were recurring features of life in the Empire State. Yet throughout all of this, many new local jobs were created in each of these states, and the persistent irritants of regional trade imbalances were wholly eradicated, and thus North Dakota, Florida, West Virginia and New York all declared themselves great again.

Close on the heels of this, a new mayor in Los Angeles was elected on a platform of technology self-sufficiency, promising to reverse the structural trade deficit his city had with its Golden State rival in I-Phones, semiconductors and all manner of electronics. Accordingly, Los Angeles invoked a punitive import duty on electronics from San Francisco and Silicon Valley. Hollywood A-listers, of course, couldn't live without their cell phones, tablets, computers and the like, and a fledgling semiconductor industry took shape in L.A. Oddly enough though, in time Los Angelenos came to realize that former Hollywood starlets really struggled to climb the learning curve in adapting to their new roles as software engineers, web developers and lean manufacturing experts. Product quality was suspect, innovation was non-existent and prices skyrocketed given sub-scale sized production facilities. San Francisco, in turn, slapped a punitive import duty on all forms of Hollywood "content", be it films, music recording, TV shows or web content. And slowly, an entertainment renaissance took hold in Silicon Valley with studios sprouting up in vacated semiconductor facilities, although most came to grudgingly agree that the region's cohort of former scientists, PhDs and software engineers somehow failed to set hearts aflutter as onscreen femme fatales.

Naturally, both Los Angeles and San Francisco declared themselves great again.

<u>Reductio ad absurdum.</u>

The above thought experiment is an illustration of the principle of comparative advantage ***<u>(in reverse)</u>***, which, as per Wikipedia is "widely regarded as one of the most powerful, yet counterintuitive insights in economics". Wikipedia notes that "David Ricardo developed the classical theory of comparative advantage in 1817 to explain why countries engage in international trade even when one country's workers are more efficient at producing *every* single good than workers in other countries. He demonstrated that if two countries capable of producing two commodities engage in the free market each country will increase its overall consumption by exporting the good for which it has a comparative advantage while importing the other good, provided that there exist differences in labor productivity between both countries."

In this new "Art of the Deal" era, wherein strong-arming trading partners in negotiations and badgering corporate decision makers is glorified, it is easy and tempting to view international trade as a zero sum game…a "deal" with a clear winner and a clear loser. This view is outdated (by 200 years), simplistic and incorrect. It ignores the principle of comparative advantage as illustrated herein, and in our view poses a tremendous risk to the decades of advancement and economic benefit that trade and globalization have brought about in every corner of the planet.

Of course, risk is merely the flipside of opportunity, and while populist and protectionist forces have dominated the conversation on trade recently, we are hopeful and even encouraged that win/win scenarios can be thoughtfully constructed in upcoming trading bloc negotiations. For instance, NAFTA, now almost 25 years old, is not without its flaws despite the tremendous benefits and the expansion of continental trade it has brought about. Accordingly, renegotiating the treaty in the spirit of finding a win/win scenario that further expands regional trade could almost certainly produce improvements and opportunities to iron out some of its current wrinkles. Similarly, the EU and the UK have the opportunity to let bygones be bygones and to negotiate a "graceful Brexit", as opposed to a "hard Brexit", in effect preserving the open markets and free trade access each side has enjoyed through the life of the union, whilst erasing those aspects of the union that are no longer politically tenable for Britons. Here at home, Canada has been blazing an exemplary path for free traders with the signing of the CETA (Canada-European Union Comprehensive Economic and Trade Agreement) in recent months and having signaled its' intent to sign the TPP (Trans-Pacific Partnership) trade accord as well. The stakes are very high in these matters, given the benefits of increasing global trade as illustrated herein, and we continue to monitor developments in this area very closely, as the macroeconomic, and in some cases, stock specific implications are quite profound.