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TARIFFS REDUCTIONS CAN BRING INFLATION RELIEF

The recent surge in inflation—by all conventional measures, the highest in decades—has grabbed attention of consumers and policymakers alike. As of April 2022, the headline consumer price index (CPI) reached 8.2% year-over-year, while core PCE—the Federal Reserve's preferred indicator—was at 4.9%. Both represent the highest increases for each since 1981 and 1982.[1]

Inflation erodes purchasing power and can, unrestrained, cause significant economic harm to consumers, workers, and businesses.[2] The Federal Reserve, as part of its dual mandate (price stability and "maximum sustainable employment," in practice a roughly 4.1% unemployment rate), aims to keep inflation at or close to 2%. On June 15, Chairman Jerome Powell announced the Federal Reserve would increase the Federal Funds Target Rate by 75 basis points, the largest increase since 1994, to combat inflation.

Inflation is the result of gross imbalances in supply and demand. The recent bout comes from both supply and demand shocks. The pandemic-induced whipsaw effect of restrained and then resurgent consumer and retailer demand has jarred an already fragile logistics system, leading to unprecedented cargo vessel backlogs, scarce warehouse space, and empty shelves.

Multiple rounds of pandemic-relief stimulus has spurred some tightening of labor markets, measured as the ratio of job vacancies to unemployment, and thus creating upward pressure on wages. According to a March 2022 research note by economists at the Federal Reserve Bank of San Francisco, these fiscal measures may have contributed about 3 percentage points to inflation by the end of 2021.

As of April 2022, the national unemployment rate stood at 3.6%, the lowest since February 2020 and what economists often consider at or near "full employment." Seasonally adjusted private sector wages and salaries in the first quarter of 2022 were up 4.9% over the same

[1] There are two common measures of inflation. The personal consumption expenditure index, or PCE index, has been since 2012 the preferred measure by the Federal Reserve for guiding monetary policy decisions. PCE measures goods and services people consume, including indirect purchases made on their behalf (such as employment-based healthcare), and is computed based on surveys of businesses. The U.S. Bureau of Economic Analysis reports both "headline" and "core" PCE, the latter net of food and energy, due to their volatility. The consumer price index, or CPI, is an alternative measure of inflation based on the average monthly change in the price of goods and services paid by urban consumers out of pocket. CPI is based on a survey of consumers, as opposed to businesses. Both indices are measured against a benchmark year but can also be presented as a change in prices in the current month compared with a previous period (usually the same month of the year prior).
[2] Deflation, or negative inflation, can be just if not more harmful, especially for borrowers whose debt obligations become more expensive to service in real terms.

period in 2021—the largest quarterly increase since the U.S. Bureau of Labor Statistics began publishing its Employment Cost Index in 2002. According to the Federal Reserve Bank of Atlanta's Wage Growth Tracker, the median wage increased 6.1% year-over-year in May 2022.

The Ukraine crisis has worsened consumer pain by driving up prices at the pump. As of mid-June, the average price for a gallon of gasoline (all formulations) nationwide broke $5, more 60% above prices from a year earlier. The average price of a gallon of gas as of May was equal to 13.9% of average hourly private earnings, the highest since 2014.

The Impact of Tariffs on Household Income

Before the recent surge in inflation, consumers were already grappling with higher costs of Chinese goods due to Trade War punitive tariff rates. These escalated duties were applied to a wide range of products, many of which of few alternatives. Tariff duties, as a type of tax, are typically passed on to households or absorbed by manufacturers, eroding profits.

Tariffs might be small relative to the amount of price increases consumers are facing nowadays. **But the elimination of Trump era Trade War tariffs could provide timely relief and help offset price increases borne by households and businesses**.

Tariffs and Prices

The trade war with China began with escalated tariffs on Chinese steel and aluminum imports under Section 232 of the 1962 Trade Expansion Act. Later in 2018, additional tariffs rates went into effect following the completion of a USTR report on unfair trade practices authorized under Section 301 of the 1974 Trade Act. Over two years, culminating in the January 2020 Phase I Trade Deal, the U.S. government imposed escalated duty rates on the equivalent of $360 billion in Chinese goods.

As of today, the United States retains a 25 percent tariff on about $160 billion of Chinese products, while another $105 billion, mostly consumer goods, are taxed at 7.5 percent. The total value of imports from all countries subject to U.S. high tariffs, penalty duties, and severe quotas summed to an estimated $610.5 billion in 2021.

The escalated duties are taxes borne by U.S. importers and, as is often the case for household goods, passed down to U.S. consumers in the form of higher prices. Researchers at the Federal Reserve Bank of San Francisco found that, as of 2019, U.S. punitive tariffs on China added 0.1 percentage points to consumer price inflation and 0.4 percentage points to business investment price inflation. A more recent paper by Houde and Wang found that a $1 tariff increase in imported Chinese solar equipment resulted in a $1.34 increase in the final price of a U.S. solar system paid by household consumers.

Tariff increases can also have a lagged effect on consumer prices. A working paper by Cavallo, Gopinath, Neiman, and Tang found that, while there may not be an immediate impact of a tariff increase on prices, this effect does take hold within a year. The authors found a ten percentage-point tariff increase on a good increased the good's price for final consumers by 0.44 percent after one year, relative to other goods in the sector.

Trade Liberalization and Tariff Relief

On June 14, news broke that the Biden Administration is considering some tariff rollbacks on Chinese goods to provide inflation relief. According to research by the Peterson Institute for

International Economics, removing lingering tariffs on Chinese products “could lower the level of the consumer price index (CPI) by 0.26 percentage point and the personal consumption expenditures price index (PCE) by 0.35 percentage point.” However, a policy briefing in March by the same institute argues a two-percentage point reduction in *tariff-equivalent barriers* (e.g., tariffs, quotas, and penalty fees) could reduce CPI by 1.3 percentage points, or about $797 per household per year.

Reducing or removing tariffs—unlike the adverse impacts of a pandemic—is entirely within the domain of the federal government. While COVID-19-induced factory closures, domestic and overseas labor shortages, retailer inventory practices, and shifting consumer behavior are far more difficult to address, tariffs are a *policy decision*. The Trade War illustrated the adverse, damaging effect of tariffs on U.S. consumers and businesses. Tariff reductions or removals, long overdue, can now also serve as a form of inflation relief for U.S. households.

Spencer Cohen, PhD *is principal and founder of High Peak Strategy LLC, an economics and research consulting firm based in Seattle. He is a 2021-2023 Public Intellectuals Program Fellow with the National Committee on U.S.-China Relations and affiliate faculty in the University of Washington Department of Geography.*