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WEEKLY ECONOMIC COMMENTARY

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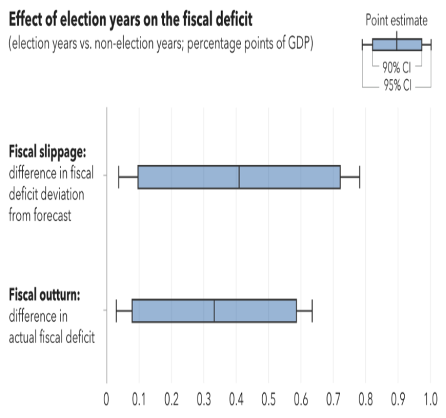
Editor's Note: This week's edition is abbreviated from its normal length, due to the upcoming long weekend. For those celebrating July 4th, we wish you a nice holiday. For those of you in the U.K. who are voting on July 4th, we wish you wisdom.

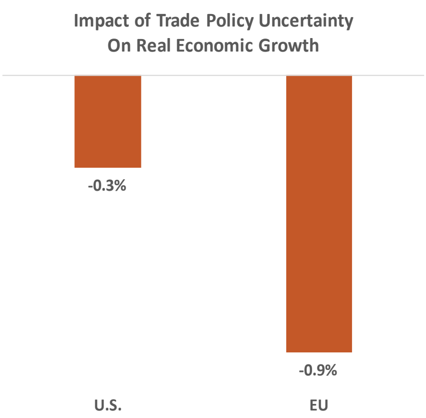
This year has been marked by an usually large number of impactful elections, with more to come. By the end of 2024, balloting covering more than 40% of the world's population and over half of global output will have taken place.

Over a billion people around the globe have already voted in this history-making year. It has been a very difficult cycle for moderates and incumbents:

- Far-right parties have gained in the European parliament.
- French President Emmanuel Macron will find governing difficult amid the polarization evident in last Sunday's voting.
- The Conservative Tories in the U.K. are staring at a massive defeat on July 4th, after 14 years in power.
- South Korea's main liberal opposition party won a landslide victory in the nation's parliamentary elections.

Even in places where ruling parties have retained power, their support has diminished. In India, prime minister Modi now heads a coalition government after losing an outright majority for the first time in a decade. South Africa's African National Congress lost its parliamentary majority for the first time since the end of Apartheid.





Sources: IMF, Goldman Sachs

Immigration, trade and the elevated costs of living have been central issues among voters, especially in the developed world. Candidates advocating a more nationalist approach to these topics have fared very well. More restrictions on the flow of people and products are likely in the years ahead. This will create special challenges for the European Union, whose members are struggling to reach consensus on border security and international commerce.

Globally, the specter of rising tariffs looms large. Former president Trump has proposed a 10% surcharge on all goods arriving into the U.S. and a 60% tariff on Chinese imports. Measures like these would exacerbate trade conflicts, fragmentation and destabilize an already shaky world economic order.

The risks to public finances in this election year are also particularly acute. Empirical evidence shows that fiscal policy tends to be looser during election years. Analysis of more than 1,100 elections in 152 countries shows that primary fiscal balances as a share of gross domestic product (GDP) decline by about 0.4 percentage points on average in election years.

This year's elections have produced outcomes that increase economic uncertainty.

This will not help with efforts to restore fiscal balance in the longer term. Government debt and deficits have soared in recent years amid rising interest burdens and the costs of energy transitions, industrial policies and defense spending. Parties gaining ground in this year's elections have proposed higher spending, which could create financial and political stress.

According to the International Monetary Fund, even a modest fiscal tightening over the medium term will not be enough to stabilize public debt across several economies. Larger fiscal adjustments than those currently predicted will be needed for attaining fiscal sustainability and rebuilding buffers. These would certainly be politically unpalatable.

In a report released last week, the Bank of England warned that the uncertainty caused by a global elections could create economic and market instability. The mere presence of uncertainty hinders international investment, which hinders growth. Election outcomes in Mexico and France had a pronounced impact on currency values and borrowing rates.

These outcomes increase the market's nervousness as we approach the November election in the United States. Politics will remain a key driver of economics in the second half of the year.

Trade Misunderstanding

Trade policy and its impact on populations have been focal points for global elections this year. This topic will certainly feature heavily in discussions leading up to the American election in November.

We thought it would be useful to provide some background on tariffs, instruments of trade policy which are often misunderstood. There is an anticipation that tariffs will be increasing in the years ahead, and bear more heavily on economic performance. Following are some foundational observations as we contemplate the consequences of these actions.

1. **Tariffs are not paid by the countries they are aimed at.** Tariffs are paid by domestic companies that import products, such as major retailers or tech companies.

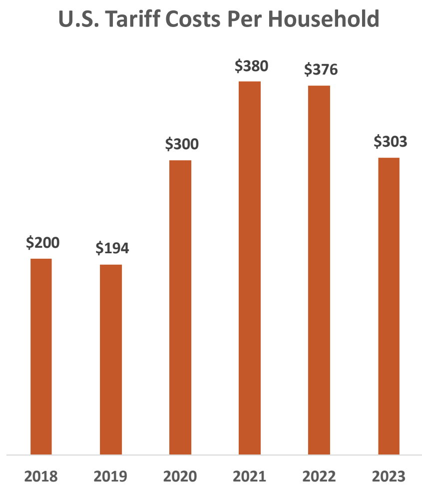
   That is not to say that countries subject to tariffs are unaffected. As their exports become more expensive, firms may shift supply chains and consumers may shift their product preferences. The loss of market share can be very costly.

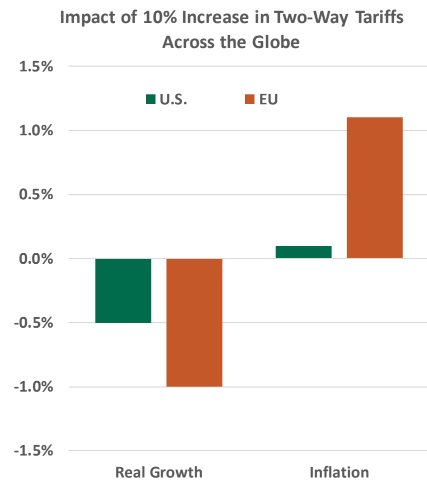
   Proponents of trade restrictions hope that these impacts will reduce anti-competitive behavior. But there is little evidence that they have this effect. Instead, they often *increase* anti-competitive behavior because…

2. **Tariffs invite retaliation.** Almost inevitably, countries subject to tariffs will strike back. In 2017, China responded to new tariffs on steel and other products by placing its own levies on American exports of soybeans and pork. More recently, new U.S. tariffs on electric vehicles and Chinese restrictions on sales of rare minerals needed for long-life batteries have created an expensive stalemate.

   A weakened World Trade Organization creates fertile ground for this kind of spiral. Evaluating the efficacy and cost of tariffs requires thinking several moves ahead.

Tariffs are costly to households and do little to promote employment.





Sources: Tax Foundation, Goldman Sachs

3. **Tariffs lead to higher inflation.** Firms that pay tariffs often pass them along in the form of higher prices. This, in turn, provides an opportunity for domestic competitors to foreign industries for raising their own prices. The costs of tariffs are ultimately paid by households.

   Research has established that higher tariffs are associated with higher levels of inflation in countries that apply them. The Peterson Institute has estimated that removing all U.S. tariffs against China would lower annual inflation by one full percent.

   To some, this is just and proper: some state-sponsored exporters sell below their costs in an effort to win market share. This type of anti-competitive behavior should be addressed. But no one likes to pay higher prices.

4. **Tariffs do not improve the economic fortunes of populations displaced by trade.** Critics of free trade correctly point to the dislocations it can produce for local workers and communities. Countries have done a very poor job of providing paths back to prosperity for those affected; as an example, the Trade Adjustment Assistance program in the United States has not come close to meeting its objectives.

   But studies suggests that tariffs have had little effect on employment levels. In fact, the negative impact that tariffs have on economic growth has the effect of *costing* jobs. And the inflation caused by tariffs hits households of more modest means the hardest.

   Viscerally, tariffs seem like a remedy for the down-sides of trade. But the evidence suggests otherwise.

5. **Tariffs are not a major source of government revenue.** Tariffs generated about $100 billion for the U.S. government in 2022, or just 2% of total revenue. There have been some recent proposals that suggest tax cuts could be paid for by increases in tariffs, but this is not realistic. Increasing tariffs would inevitably cause substitution away from the products in question, which would severely limit any incremental proceeds.

   Further, the combined impact of tax cuts and tariff increases would be very regressive. Reduced taxes would be beneficial to higher income groups, while tariff-related inflation would be most costly to those in the lower quintiles.

There are lots of claims and counterclaims when it comes to tariffs. In situations like this, it is critical to know the facts and to use them in setting policy. To do otherwise risks bad outcomes.

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