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What's at stake in the US-Mexico tariff dispute?
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GERTZ: I'm Geoffrey Gertz, a Fellow in the Global Economy and Development Program at the Brookings Institution, and today I'm filling in for David Dollar to discuss the ongoing tariff dispute between the US and Mexico.

Last week, on Thursday May 30th, the Trump administration announced a new plan to impose across-the-board tariffs on Mexico. Trump declared that unless and until Mexico is able to substantially resolve the illegal immigration crisis, the United States would begin charging tariffs on all imports from Mexico. Tariffs are due to start being collected on Monday June 10th, at a rate of 5 percent. Every month after that, so long as the immigration crisis is still not resolved, the rate will increase by a further 5 percent, until ultimately reaching 25 percent in October.

This announcement came as a shock to both American and Mexican audiences, and there is still lots of uncertainty over what will happen next. In this podcast I discuss whether the tariffs are likely to be implemented, what will be the costs to both Mexico and the United States if they are imposed, and what this episode can tell us about America's longer term foreign economic policy.

So first off, is this likely to happen? And the answer is it's very difficult to know. Throughout Trump's presidency, he has repeatedly made bold announcements about dramatic policy changes, but then either walked back the ultimate implementation or seemingly forgot about it all together. This is especially the case when it comes to trade policy. At various times Trump has floated ideas of withdrawing from NAFTA, withdrawing from the World Trade Organization, or rejoining the Asian trade pact the—Trans Pacific Partnership, or TPP—after he had already withdrawn from it. His steel and aluminum tariffs meanwhile were announced, then repeatedly delayed, then half-heartedly implemented for some countries but not others. In brief, we shouldn't assume that just because Trump has threatened to impose tariffs he necessarily will – he has a history of not following through on these matters.

There are two particular reasons why these tariffs might not be imposed. First, reporting suggests that this decision was made by Trump and his immigration advisor, Steven Miller, against the advice of almost all of Trump's trade and economic team. Thus, there are clearly some people within the administration that would be happy to see this problem go away, and they may be able to convince the President to change his mind.

Second, the policy as announced is extremely vague on what Mexico must actually do to meet American demands on immigration policy. Trump has called for the Mexican government to completely end unauthorized migration through its country, but this is an impossible request. It seems possible that Mexico may be able to make some relatively minor concessions of ramping up border enforcement, and this will be enough to allow Trump to claim victory and call off the tariffs. At the time of recording, U.S. and Mexican officials are meeting in Washington attempting to reach such a deal. Trump has said that not enough progress has been made so far, but at any point he could decide that this tariff threat has served its purpose. Ultimately, however, Trump's trade policy remains very unpredictable, and if nothing changes tariffs will go into effect on Monday.

That brings me to the second point I want to discuss, which is the economic and political ramifications of the tariffs if they are imposed.

The costs to Mexico could be substantial, which is why Mexican officials are taking this threat very seriously. Nearly 80 percent of Mexico's exports go to the United States, so upending that trade could cripple Mexico's economy. As noted, the tariffs will begin at 5 percent on Monday and then increase by 5 percent each month after that up to 25 percent. A 5 percent tariff will be difficult but manageable, not least because the dollar-peso exchange rate has already depreciated enough to effectively cancel out the tariff effect. But tariffs of 25 percent would be very damaging, and high enough that over time they could lead to trade divergence as American importers seek out alternative suppliers.

While 25 percent tariffs would be painful to Mexico, they would also seriously hurt the American economy. Tariffs are taxes paid by American importers. American imports from Mexico include lots of cars and car parts, technology equipment such as computers, and appliances such as fridges and washing machines. Starting Monday, if the tariffs are in place American companies will be paying more to bring those goods in from Mexico, and based on recent history, are very likely to pass on those higher costs to U.S. consumers.

The economic cost of the tariffs is multiplied by the fact that supply chains often cross the U.S.-Mexico border several times. For example, by the time a fully assembled car is sold in the United States, for example, many parts have crossed back and forth between the U.S. and Mexico multiple times as parts are built at one location, assembled in another, and then sent on to a third location to be installed in a vehicle. NAFTA, which eliminated almost all tariffs between the US, Canada, and Mexico, made these production chains seamless. But if tariffs are paid each time a good crosses the border, the costs could quickly become prohibitive.

While the economic costs are high, the political costs of the Mexico tariffs may actually be higher – and they directly threaten Trump's own political interests. Trump is heading into a difficult election season as an unpopular incumbent but with two big points to campaign on. First, the economy is doing well – unemployment is low, consumer sentiment is generally high, and inflation has remained modest. And second, in 2016 he ran promising to renegotiate NAFTA, and his administration has successfully concluded a new trade deal, the US-Mexico-Canada Agreement, or USMCA.

The Mexico tariffs threaten both of these accomplishments. As already noted, the tariffs will pose costs to the American economy, and to consumer sentiment in particular. While the 5 percent tariffs might only have a minimal impact, but an extended period of 25 percent tariffs would have a big effect, especially in border states of Texas, Arizona, and California, as well as Michigan, home to the US auto industry. A strong economy is Trump's best re-election argument at this point, yet his own actions are threatening it.

With respect to USMCA, while the agreement has been signed, it has not yet been ratified. All three countries will need to pass legislation before the new treaty comes in to effect. It is extremely unlikely that Mexico will vote to ratify the agreement while facing the threat of new tariffs. At the same time, the Mexico tariffs have also imperiled Congressional support for the deal, which was already shaky. Almost all Democrats and many Republicans in Congress strongly oppose the Mexico tariffs. Trump would like to be able to claim on the campaign trail that he replaced NAFTA as he promised he would, but Congress is highly unlikely to approve USMCA while the Mexico tariffs are in place.

The economic and political costs of the tariffs are another reason why Trump may ultimately decide not to implement them. Yet even if he does back down, this episode will still have lingering effects. The Trump administration is demonstrating that the US is a rash and unreliable ally, willing to hold other economies hostage to its own impulsive whims. No foreign leader watching this outburst would conclude that the US is a good partner to build a closer relationship with, and they will remember this fact going forward. Ever since Trump came to power, many traditional allies of the US have been slowly working to decrease their dependence on the United States. For now, America maintains its central place in the global economy, but bit by bit this privileged position is being eroded. While not an immediately visible crisis, over the long term this will have serious economic and diplomatic costs.