The Economic Effects of Trade Policy Uncertainty

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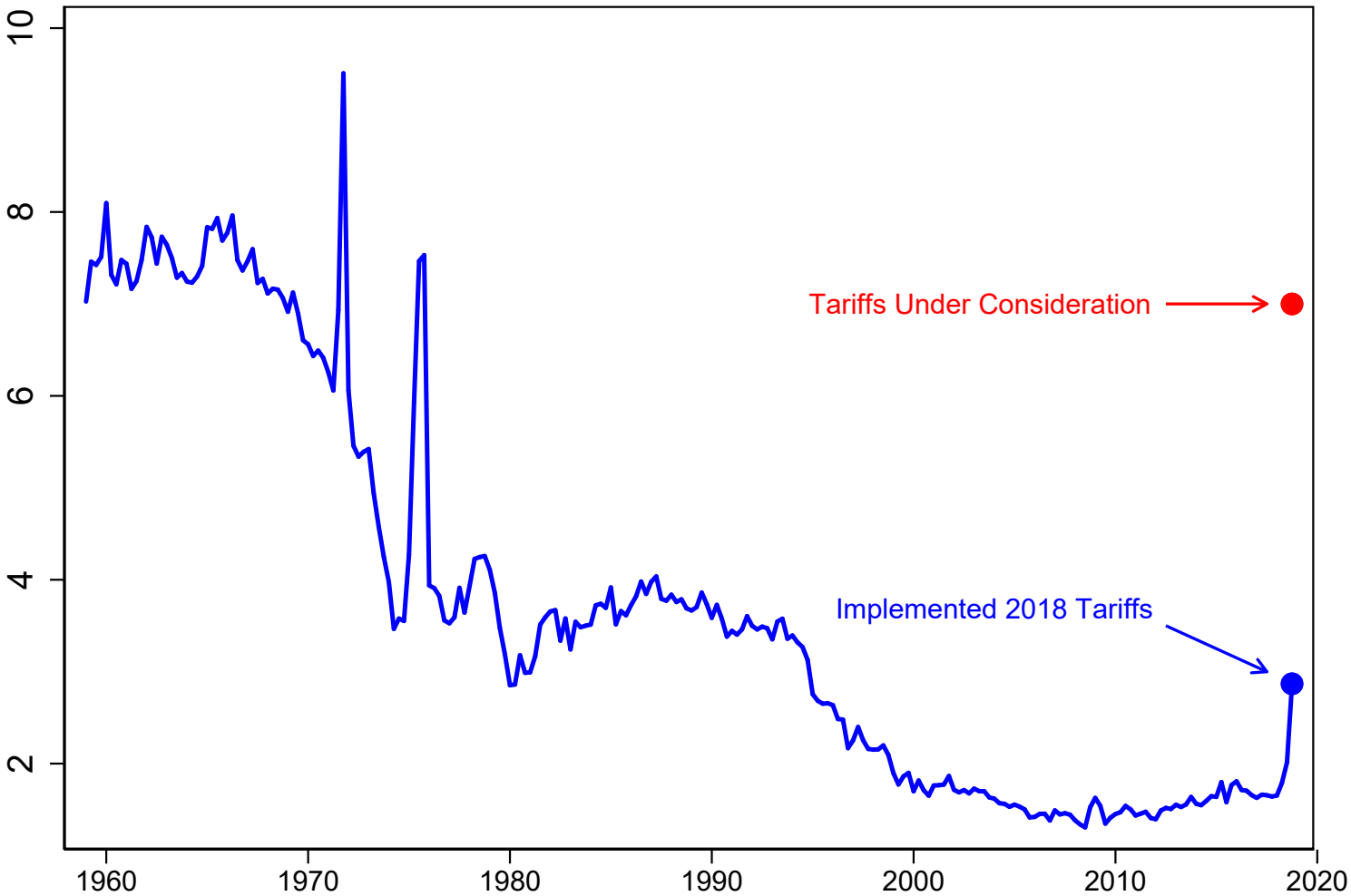
The End of Free Trade?



U.S. Import Tariffs as % Share of Total Imports of Goods

Forward to Model

Our Contribution

We study effects of trade policy uncertainty (TPU) on U.S. economy

1. **Measurement**: We construct 3 TPU measures based on firm-level and aggregate data

2. **Quantification**: We provide firm-level and aggregate evidence that higher TPU reduced U.S. investment by about 1.5 percent in 2018

3. **Transmission**: We use an open-economy DSGE model to highlight how risk and uncertainty about trade policy affect economic activity

Firm-Level TPU

Measuring Firm-Level TPU: Data

We construct firm-level measures of TPU from earning call transcripts for publicly listed companies (see also Hassan et al., 2017)

Each earning call follows a common two-part format:

1. Performance review of the last quarter
2. Q&A sessions with investors and analysts.
   - They contain information about risks faced by firm

Our sample: 160,000 transcripts, 7,500 firms, 2005Q1-2018Q4.

Measuring Firm-Level TPU: Textual Analysis

We proceed in two steps:

1. Search the earning call transcripts for trade policy (TP) terms
   - E.g., *tariff**, *import dut**, *import barrier**, *trade polic**
   - Frequency of TP matches indicates the intensity of trade policy discussions in a conference call

2. Search for uncertainty (U) terms in close proximity to TP terms
   - E.g., *risk**, *threat**, *tension**, *uncertain**
   - Must appear within **10** words

TPU = Number of joint instances of TP and Uncertainty (normalized by number of words in the call)

Examples of *TP* and *TPU*

TP:

Goodyear Tire & Rubber - 2013Q3

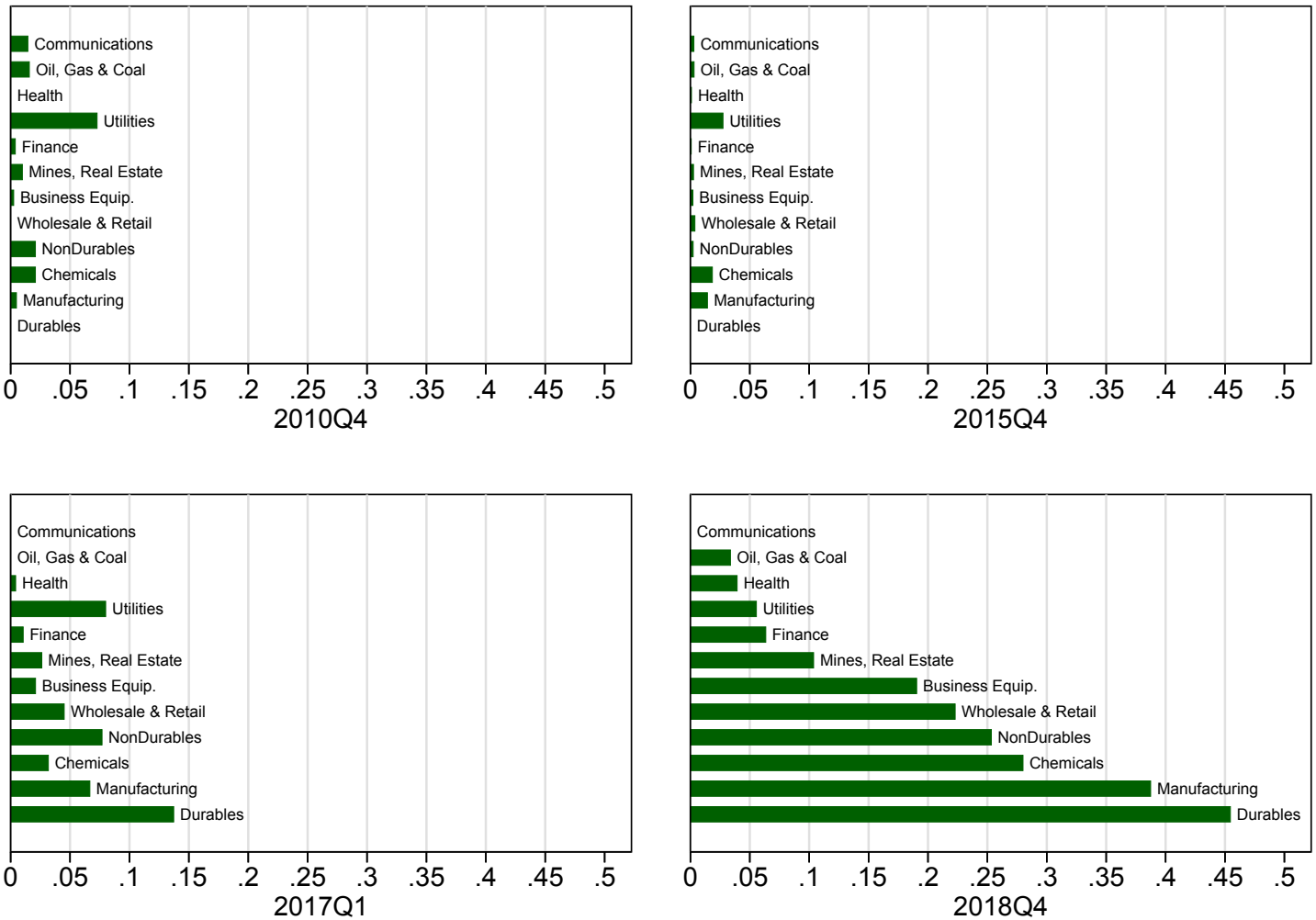
- *"You will note for the fourth quarter, however, that North America will be down year over year, again reflecting the aberration of a year ago, when fourth-quarter dealer orders for low-end tires were high post expiration of Chinese tire* **tariffs***."*

TPU:

Levi & Strauss Co. - 2018Q1

- *"The biggest uncertainty I think we're facing. There are really two, and I don't know if I want to rank them, but one is the* **uncertainty** *around trade and* **tariffs***. That could have significant short-term impact."*

Variation Across Industries and Time



Note: Share of firms in the industry mentioning TPU in their earnings calls

Comparison with Hassan et al. (2016)

Quantifying the Effects of Firm-Level TPU on Investment

- We use Compustat balance-sheet data over 2015Q1-2018Q4
- (Cumulative) Investment constructed from fixed assets $k_{i,t}$ as:

$$\log k_{i,t+h} - \log k_{i,t-1}, \text{ where } h \geq 0$$

- We estimate, for $h = 0, 1, 2, 3, 4$:

$$\log k_{i,t+h} - \log k_{i,t-1} = \alpha_i + \alpha_{s,t} + \beta_h TPU_{i,t} + \Gamma' X_{i,t} + \varepsilon_{i,t}$$

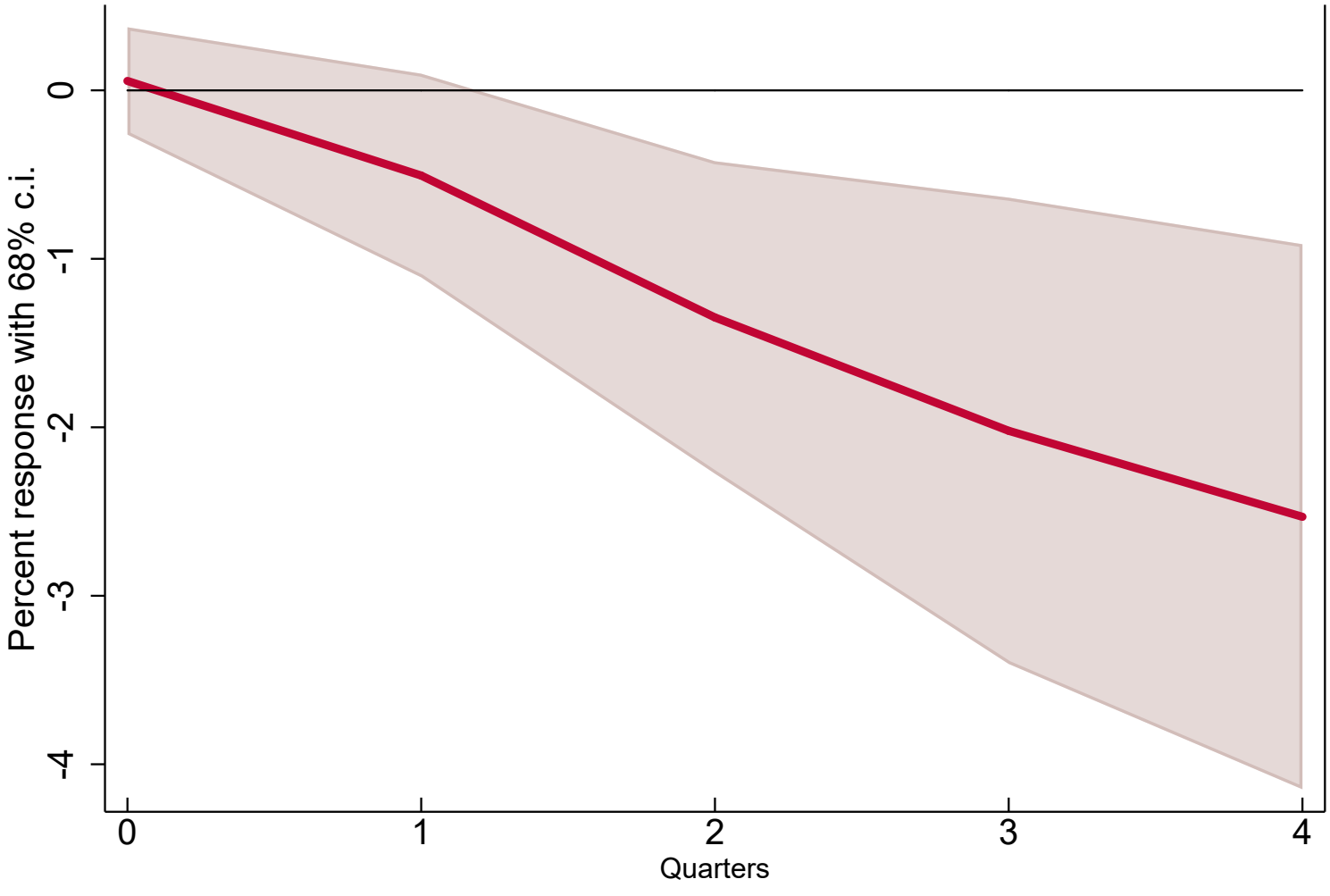
- α_i and $\alpha_{s,t}$: firm and sector-by-quarter fixed effects

  $X_{i,t}$: Tobin's q, cash-flow, openness, $TPX_{i,t} = TP_{i,t} - TPU_{i,t}$

  β_h: response of $\log k$ in $t + h$ to change in TPU in quarter t

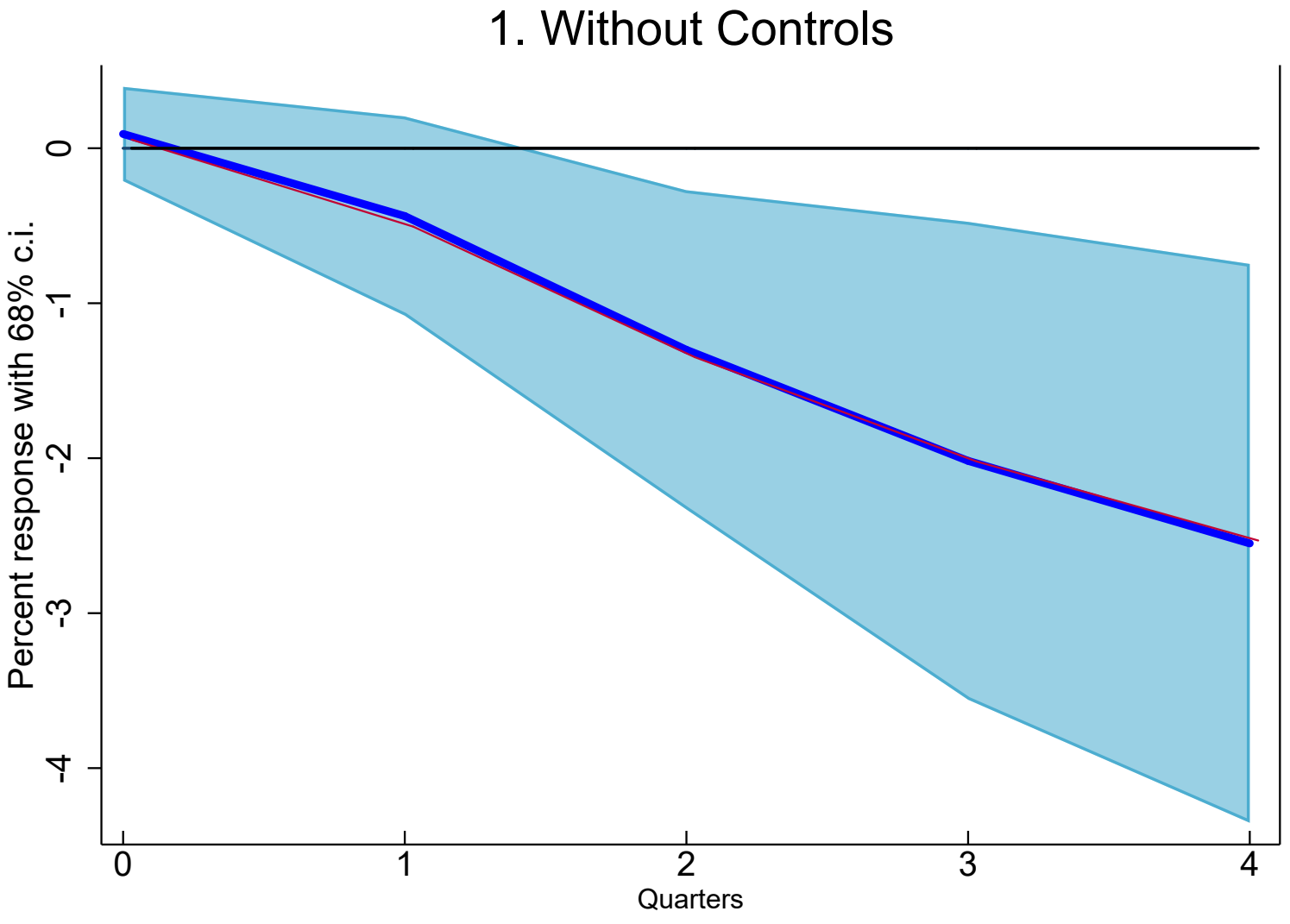
- We restrict sample to firms in manufacturing, agriculture and mining

Firm-Level Response to High TPU



Cumulative response of log assets after increase in *TPU* Cross-Section in 2018

Local Projections: Robustness



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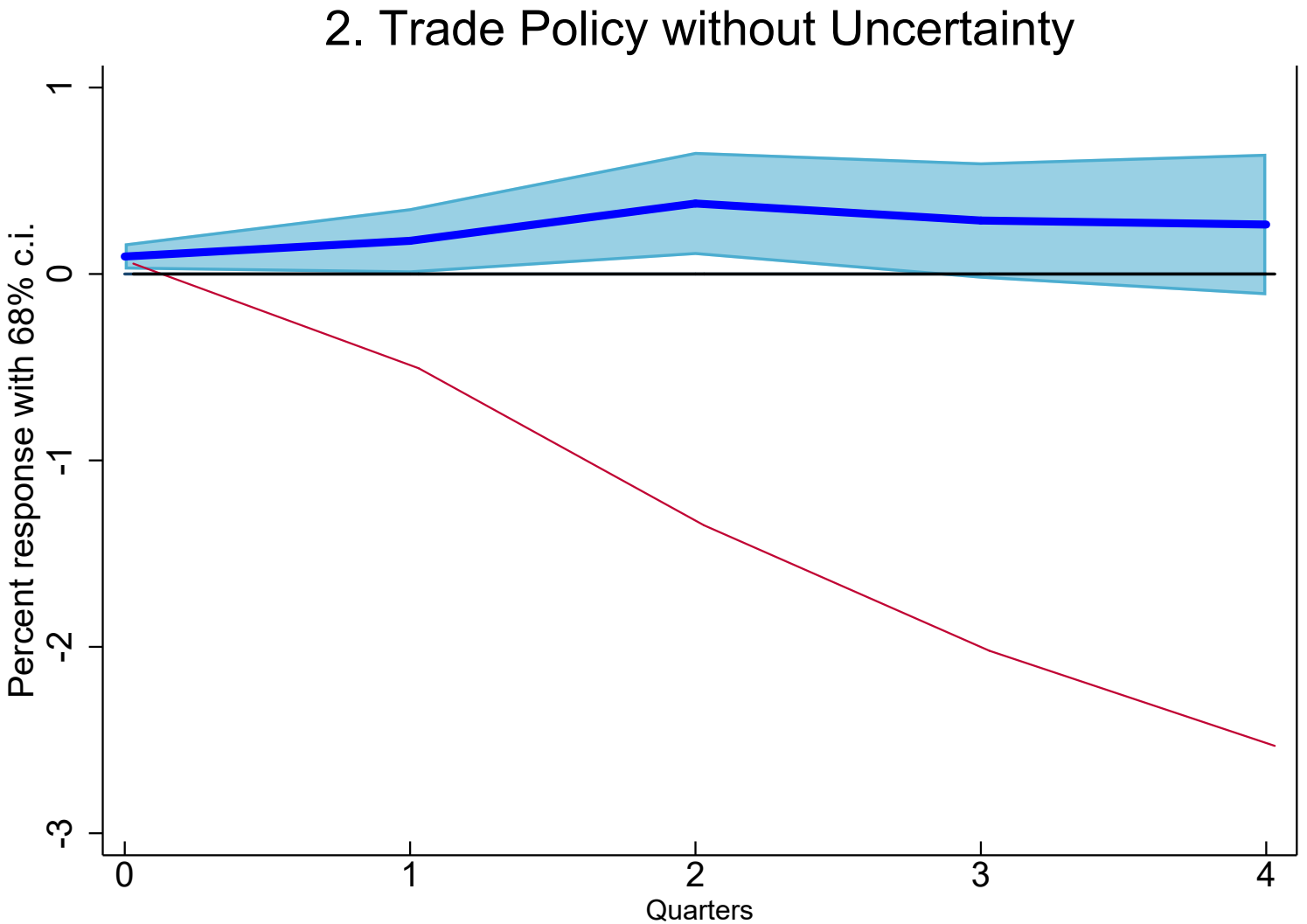


Additional Robustness (no Time Effects)

Aggregation of Firm-Level Estimates

Our estimates imply that the 2018 increase in TPU reduced U.S. investment by 1 percent through direct firm-level effects:

$$\underbrace{-2.5\%}_{\substack{\text{effect on K}\\ \text{of firm}\\ \text{hit in 2018}}} \times \underbrace{10\%}_{\substack{\text{share of firms}\\ \text{hit by high}\\ \text{TPU in 2018}}} \times \underbrace{43\%}_{\substack{\text{asset share of}\\ \text{mfg. firms}}} \times \underbrace{\$24 \text{ tn}}_{\substack{\text{stock of US}\\ \text{fixed assets}\\ \text{in 2018}}} \div \underbrace{\$2.8 \text{ tn}}_{\substack{\text{US investment}\\ \text{in 2018}}} \simeq \underbrace{-1\%}_{\substack{\text{decline in}\\ \text{private}\\ \text{investment}}}$$

Note: Calculation ignores indirect effects through general equilibrium channels.

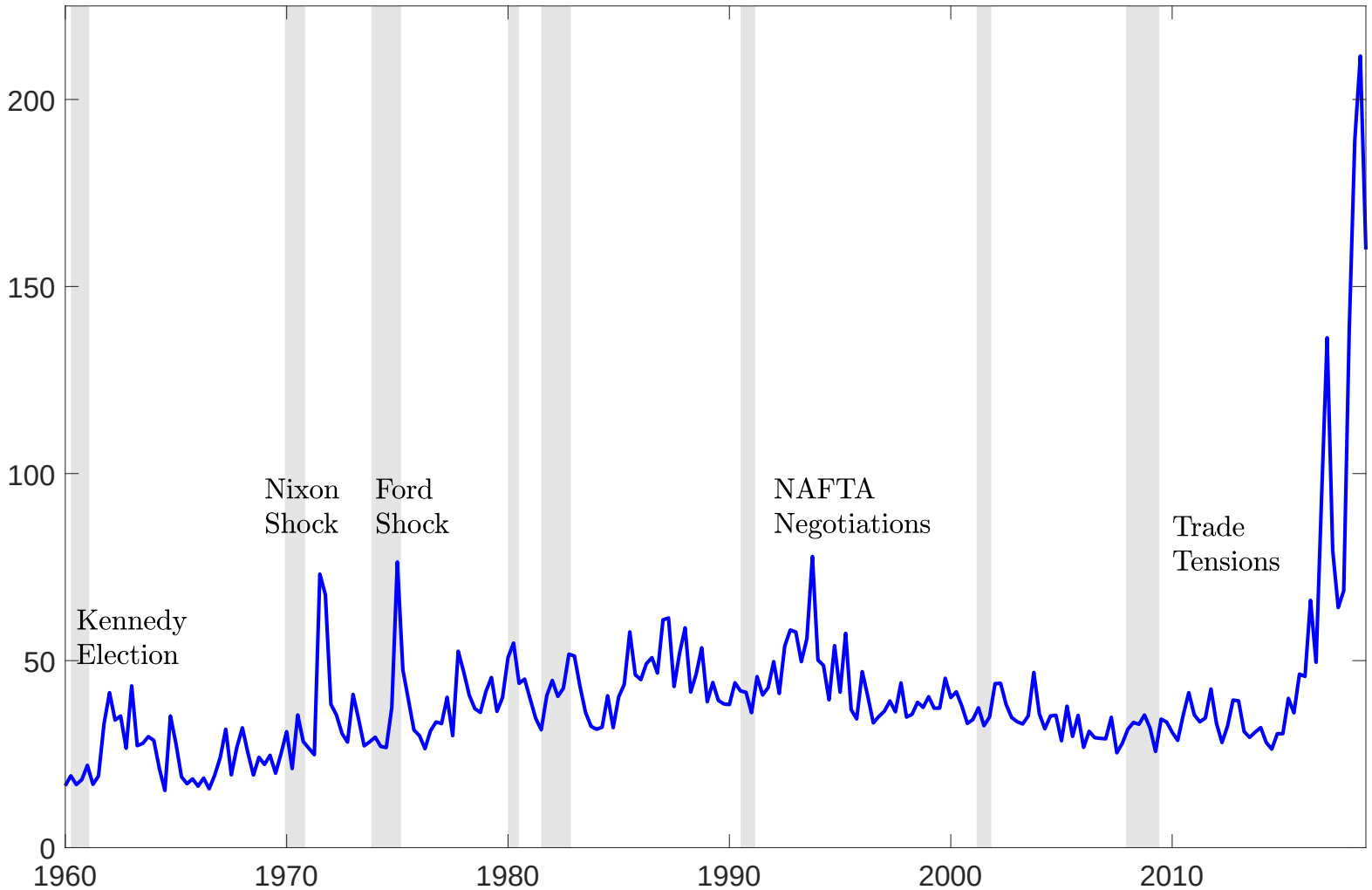
Aggregate TPU

Measuring Aggregate TPU

1. News-Based Using Textual Analysis (Baker et al., 2016)

- We search for TPU words in newspaper articles
- Hence, this index captures TPU as perceived by press

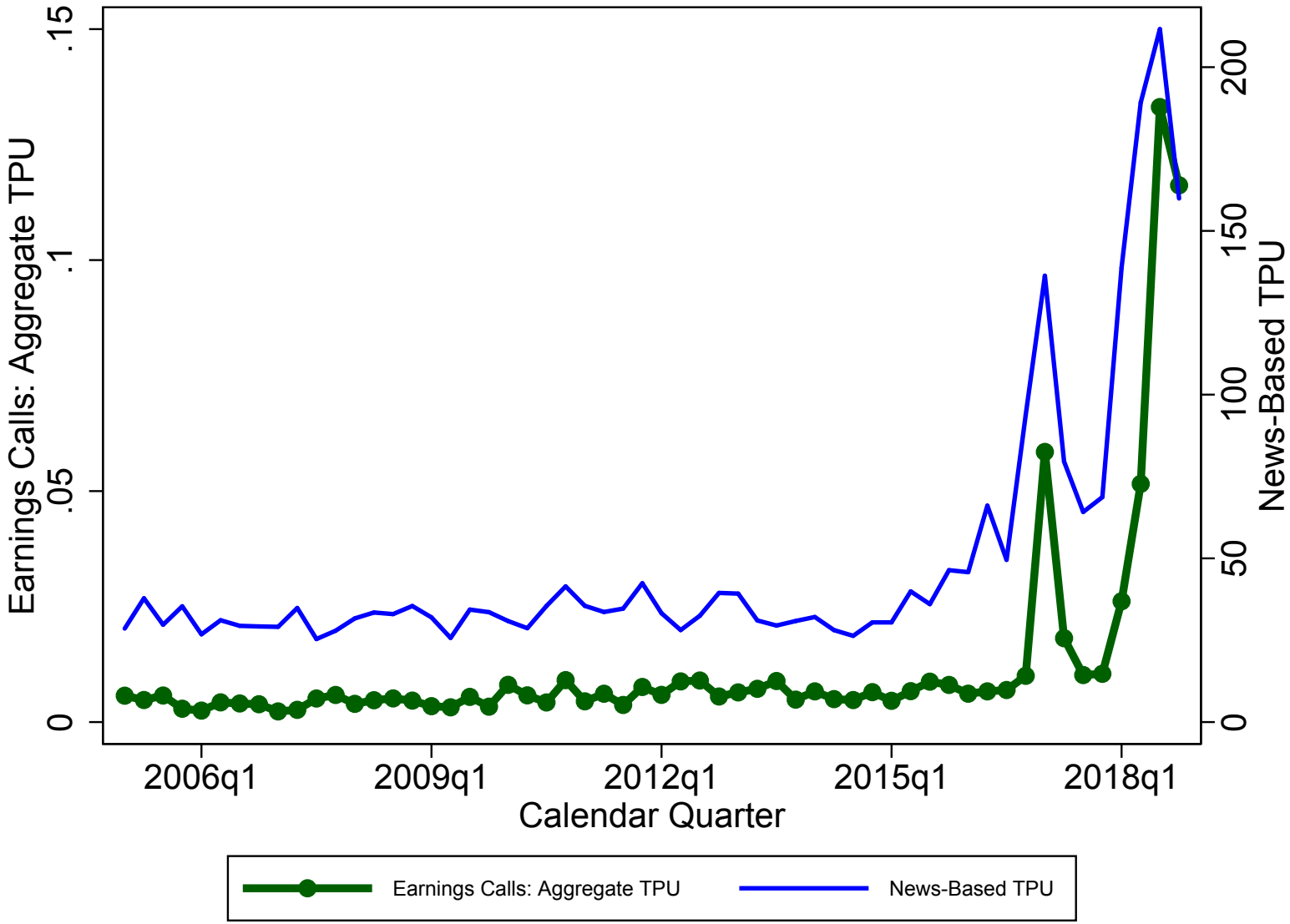
News-Based TPU



Index=100 when share of articles mentioning *TPU* is 1 percent

Comparison with Baker et al. (2016)

News-Based vs. Earnings Calls Based TPU



Foreign Firms TPU

Measuring Aggregate TPU

1. News-Based Using Textual Analysis (Baker et al., 2016)

- We search for TPU words in newspaper articles
- Hence, this index captures TPU as perceived by press

2. Stochastic Volatility Using Tariff Data (Fernandez-Villaverde et al., 2015)

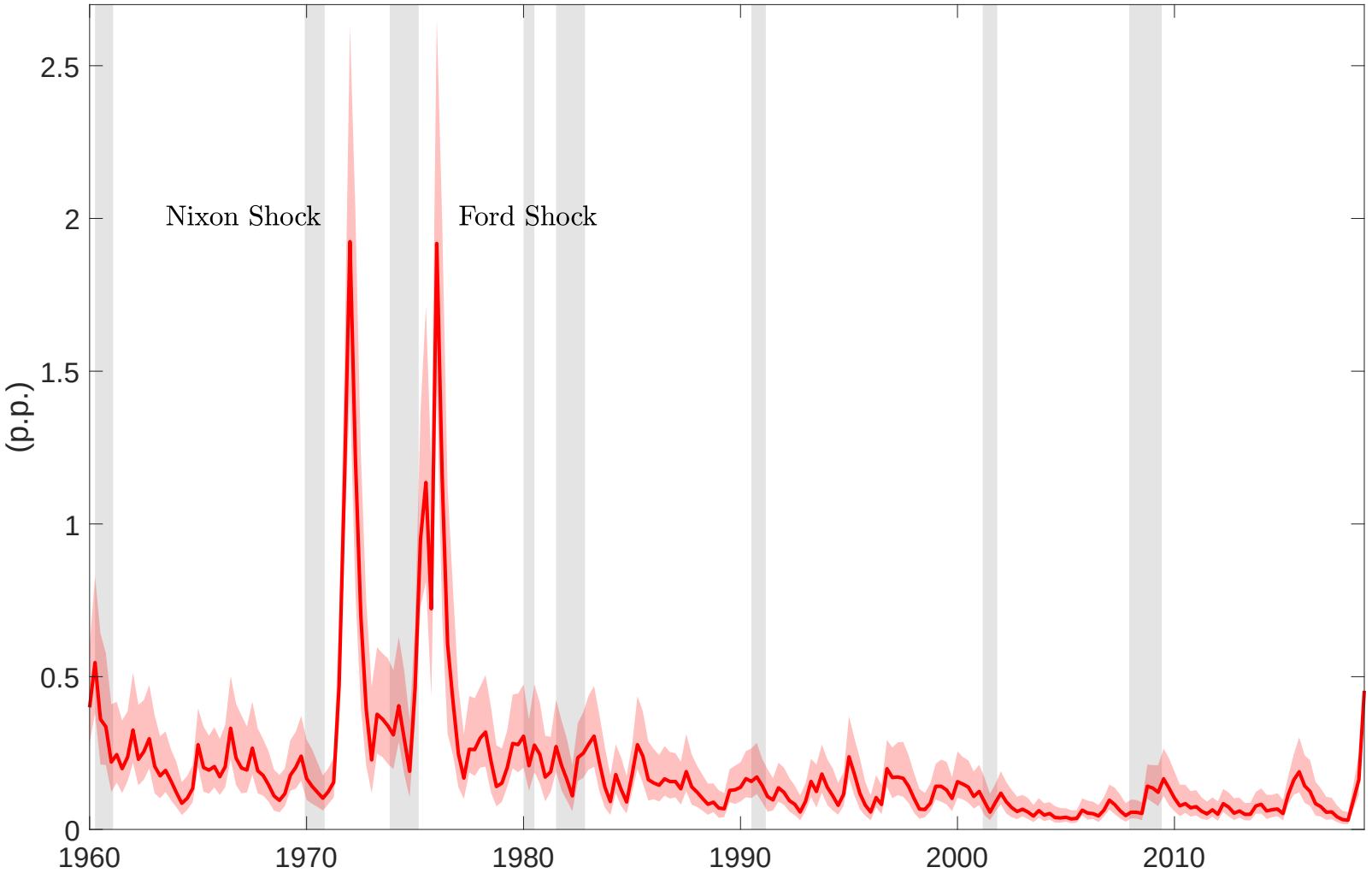
- We estimate the process:

$$\tau_t = (1-\rho_\tau)\,\mu_\tau + \rho_\tau \tau_{t-1} + \exp(\sigma_t)\,\varepsilon_t, \quad \varepsilon_t \sim N(0,1)$$

$$\sigma_t = (1-\rho_\sigma)\,\sigma + \rho_\sigma \sigma_{t-1} + \eta\, u_t, \quad u_t \sim N(0,1)$$

- u_t affects spread of values for tariffs (i.e. tariff volatility shock)

Tariff Volatility TPU



Filtered series of tariff volatility. Shaded area: 68-percent credible sets.

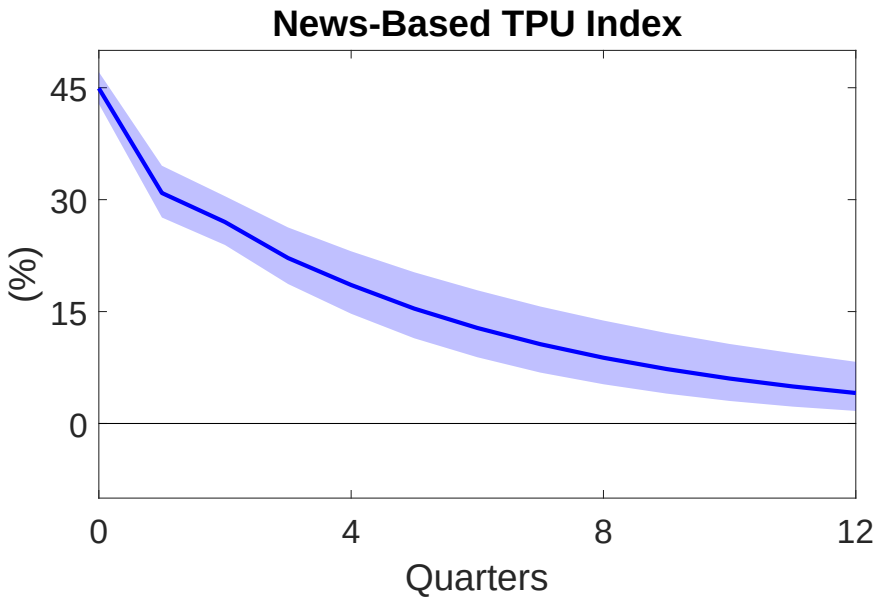
Comparison with news-based TPU

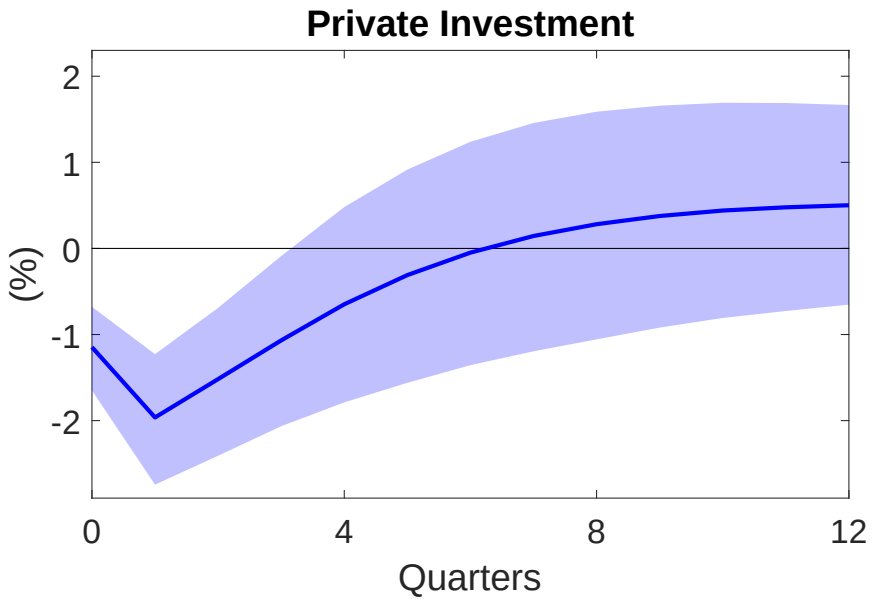
Quantifying the Effects of Aggregate TPU

- Estimation of VAR
- Baseline specification and ordering:
  1. News-Based TPU
  2. Real business fixed investment per capita
- Alternative specifications (see paper):
  - Tariff volatility TPU:
  - Additional controls: tariff rate, real GDP per capita, JLN uncertainty, exchange rate, tax rate on capital income.
- Sample: 1960Q1-2018Q4
- Consider IRFs to 2-standard deviation shock

Correlation with other shocks

Aggregate Effects: Baseline VAR





SV TPU Larger VAR

Taking Stock of the Empirical Evidence

- 2018 Increase in Firm-Level TPU

  $\rightarrow$ K of manufacturing firms drops 2.5 percent after 1 year

  $\rightarrow \simeq$ 1 percent decline ($25 bn) in aggregate U.S. fixed investment.

- 2 standard deviations increase in aggregate TPU
  (comparable to recent developments)

  $\rightarrow \simeq$ 2 percent decline in U.S. investment.

TPU Transmission:DSGE Model

Framework

- Medium-scale DSGE model featuring:
  - Two countries specializing in production of traded intermediate inputs
  - Armington CES aggregator for traded intermediate inputs
  - Sticky prices and wages
  - Investment adjustment costs
  - Entry into and exit from export market (as in Alessandria and Choi, 2007)
- Goal: Trace out aggregate GE effects and firm-level effects of an increase in TPU.
- Assumption: Tariffs are perfectly correlated across countries (full retaliation).

Effects of Tariffs

- Tariffs increase the relative price of imported goods $\rightarrow$ consumers switch towards domestic varieties Demand switching
- Tariffs induce supply-side distortions: They act like taxes on K and L Supply Distortion
- Tariffs reduce the value of exporting $\rightarrow$ mass of exporters shrinks and aggregate productivity declines Entry Distortion

Experiment: An Increase in TPU

- We isolate two effects of an increase in TPU
  - Rise in expected tariffs (first moment)
  - Mean-preserving increase in the volatility of future tariffs (second moment)

- Tariffs follow a SV process with news:

$$\tau_t^m = (1-\rho_\tau)\,\mu_\tau + \rho_\tau \tau_{t-1}^m + \exp\left(\sigma_{t-1}^m\right)\varepsilon_t^\tau + \varepsilon_{t-1}^N \tag{1}$$

$$\sigma_t^m = (1-\rho_{\sigma^m})\,\sigma^m + \rho_{\sigma^m}\sigma_{t-1}^m + \eta\, u_t \tag{2}$$

  where $\left\{\varepsilon_t^N\right\}_{t=0}^T$ is a news shock about the level of future tariffs

- We calibrate the parameters of this SV process using the empirical estimates

Experiment: Calibration of the Shocks

1. Time 0: Agents learn that there is probability $p_0 = \frac{1}{2}$ that tariffs increase from $\tau^{SS} = 0.02$ to $\tau^{HIGH} = 0.08$ Tariff Rates

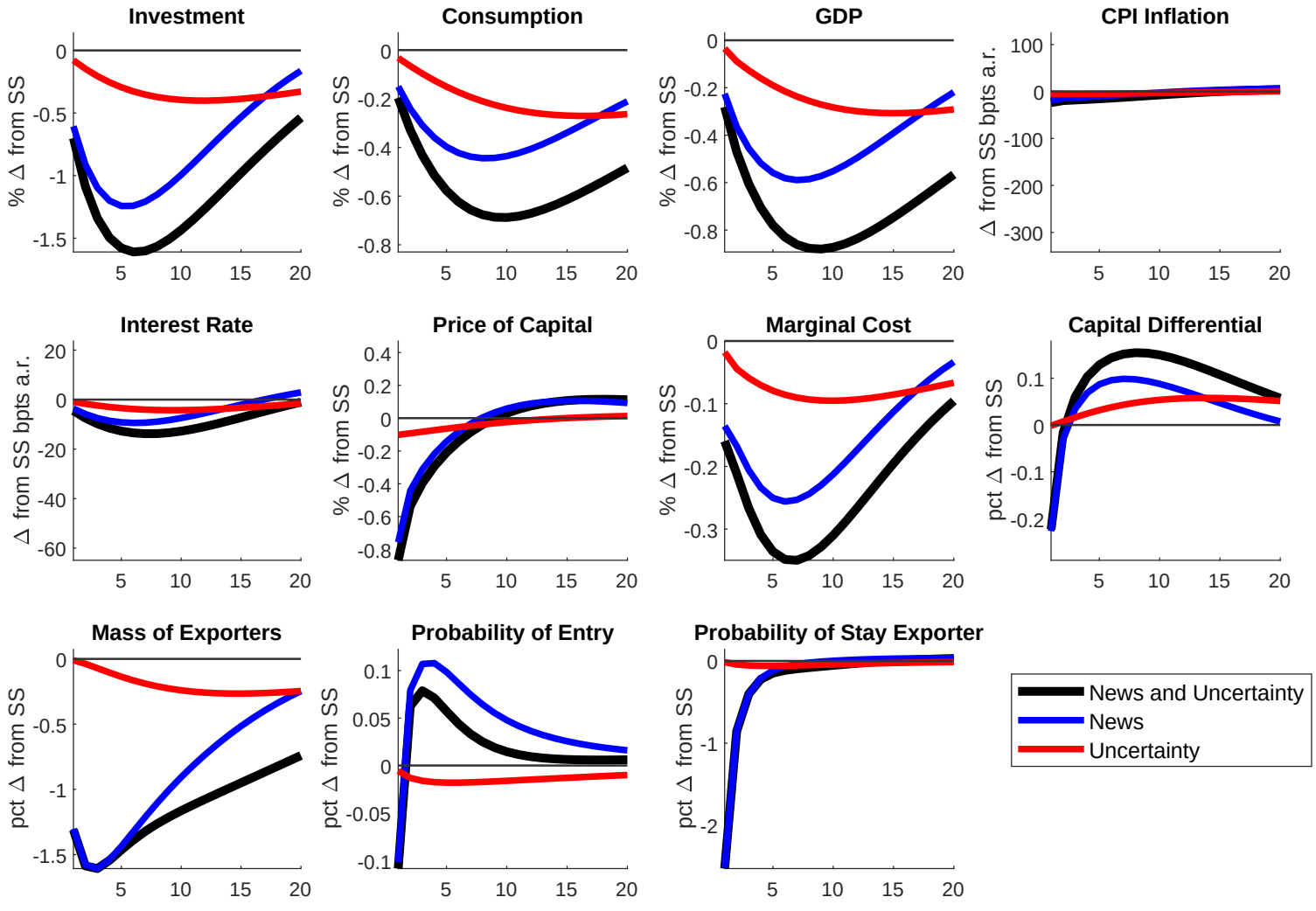
$$\varepsilon_0^N = p_0 \cdot 0.08 + (1 - p_0) \cdot 0.02 = 0.03$$

$$\sigma_0^m = \sigma^m(p_0) = \log(0.03)$$

where $\sigma^m(p)$ satisfies $\exp(\sigma^m) = \Delta\tau^m \sqrt{p(1-p)}$

2. From $t = 1, ..., T$ **no change in tariffs occurs** i.e. $\tau_t^m = \tau^{SS}$ but **uncertainty about tariffs persists**:
   - As agents observe no increase in tariffs they update p_t so that $\sigma^m(p_t) = \sigma_t^m$ follows SV law of motion (2)
   - Expectation of tariffs adjust accordingly: $\varepsilon_t^N = p_t \cdot 0.08 + (1 - p_t) \cdot 0.02$

Model Experiment 1: Results



Tariff News: Channels of Transmission

News Effects

- Intertemporal Substitution:
  Higher future tariffs make current C and I relatively cheaper

$$\tilde{c}_t = \tilde{c}_{t+1} - \frac{1}{\sigma}\tilde{r}_{t+1}(\underline{\tau}^m_{t+1})$$

$$\tilde{p}^k_t = r^k \tilde{r}^k_{t+1} + (1-\delta)\,\tilde{p}^k_{t+1} - \tilde{r}_{t+1}(\underline{\tau}^m_{t+1})$$

- Investment demand falls:
  Higher future tariffs lower expected asset prices

$$\tilde{p}^k_t = r^k \tilde{r}^k_{t+1}(\underline{\tau}^m_{t+1}) + (1-\delta)\,\tilde{p}^k_{t+1}(\underline{\tau}^m_{t+1}) - \tilde{r}_{t+1}(\underline{\tau}^m_{t+1})$$

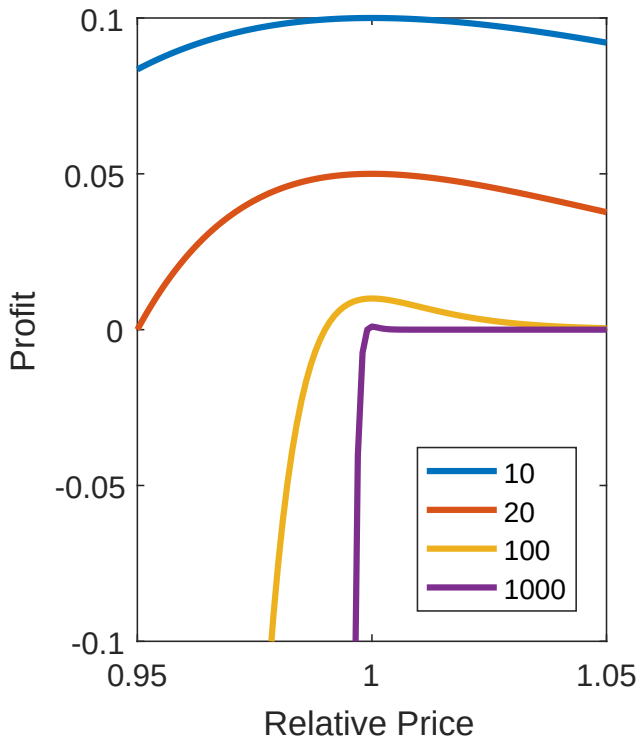
- With sticky prices, real interest rate does not drop much and second channel dominates.

Uncertainty: Channels of Transmission

Uncertainty Effects

1. Aggregate demand falls because of precautionary motive.
2. Markups increase. (as in Fernandez-Villaverde et al., 2015)

- Uncertainty about tariffs increases the variance of future desired prices.
- When different varieties are substitutes, profit function is asymmetric → losses from overpricing smaller than losses from underpricing.



- Producers raise prices to avoid being stuck with relatively low price in the future → markups rise, especially in foreign market.

Taking Stock of the Model Results

- 2018 increase in TPU lowers investment by nearly 1 percent
  - Experiment 1 (mean effect): Anticipation of higher tariffs reduces investment by about 0.5 percent
  - Experiment 2 (variance effect): Uncertainty about future tariffs reduces investment by 0.3 percent

Conclusions

- **Measurement**: We construct firm-level and aggregate measures of TPU using both textual analysis and estimation of a stochastic volatility process.
- **Quantification**: We provide empirical evidence that the 2018 increase in TPU may have reduced U.S. investment by about 1-2 percent.
- **Transmission**: We study quantitatively the role of changes in expected tariffs and in volatility of future tariffs in an open-economy DSGE model with heterogenous firms and sticky prices.

References I

Alessandria, G. and Choi, H. (2007). Do sunk costs of exporting matter for net export dynamics? *The Quarterly Journal of Economics*, 122(1):289–336.

Baker, S. R., Bloom, N., and Davis, S. J. (2016). Measuring economic policy uncertainty*. *The Quarterly Journal of Economics*, 131(4):1593.

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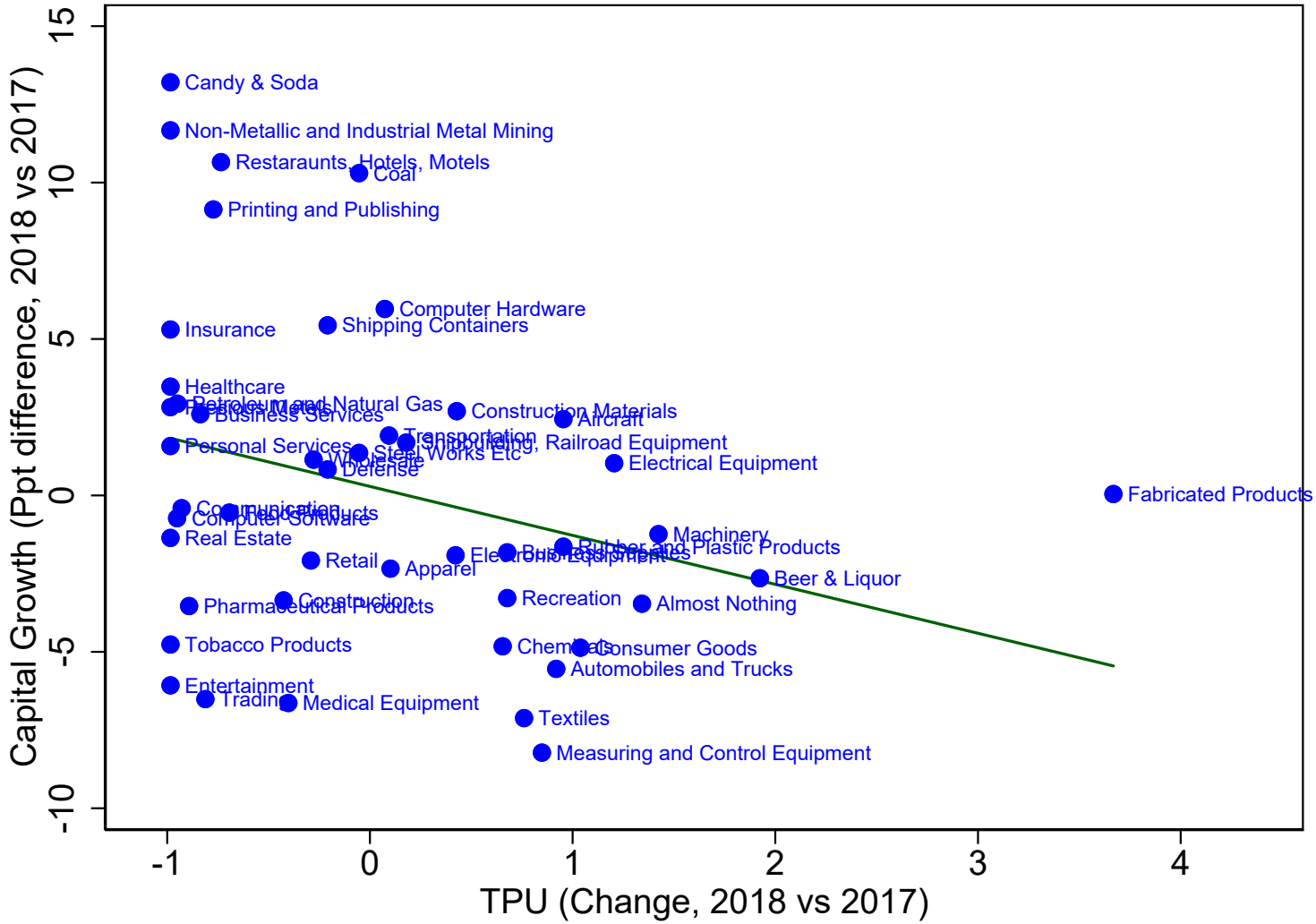
Hassan, T. A., Hollander, S., van Lent, L., and Tahoun, A. (2017). Firm-Level Political Risk: Measurement and Effects. NBER Working Papers 24029, National Bureau of Economic Research, Inc.

Cross-Section: 2018 vs.2017 Investment Growth



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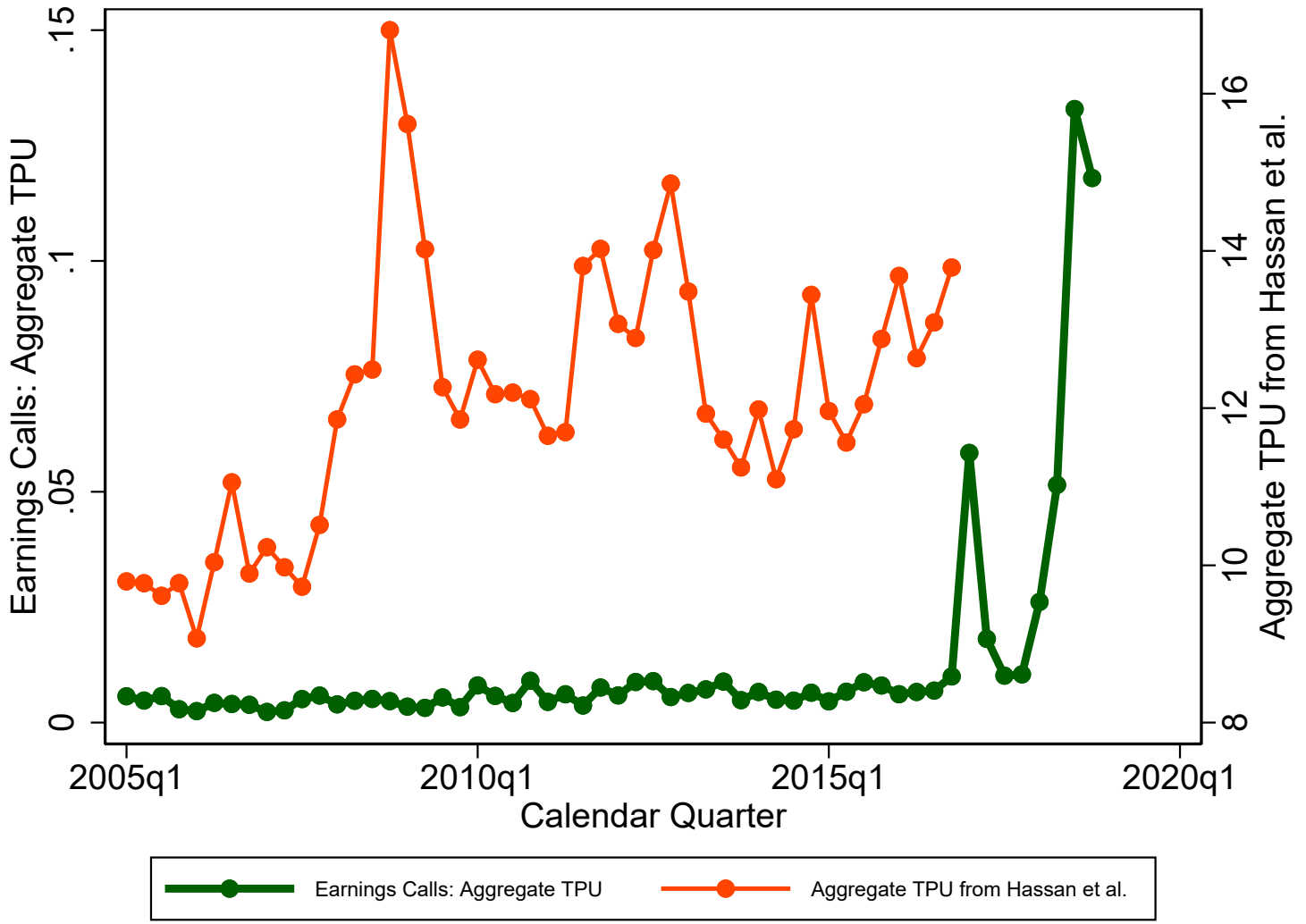
TPU from Hassan et al. (2016)



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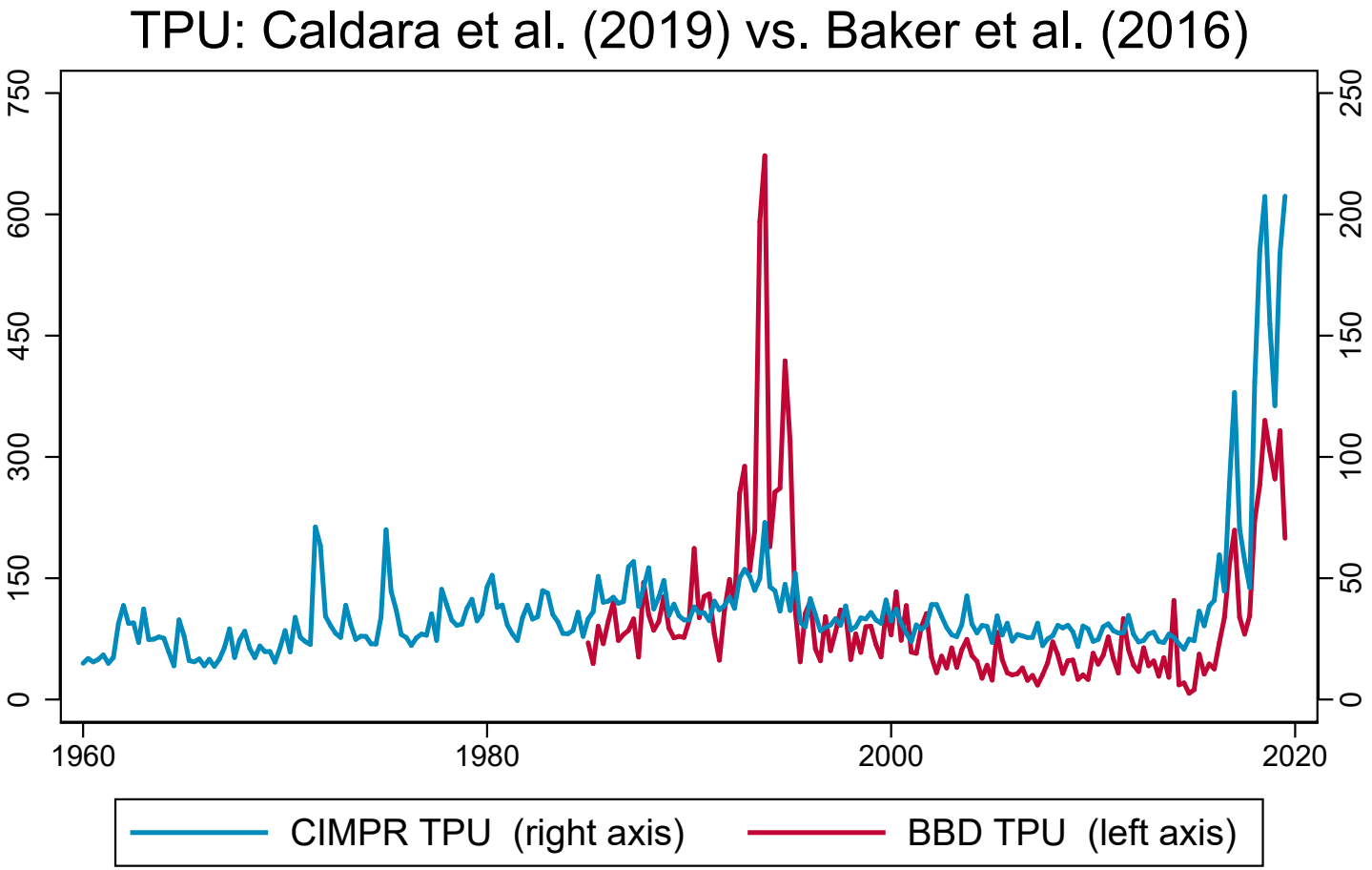

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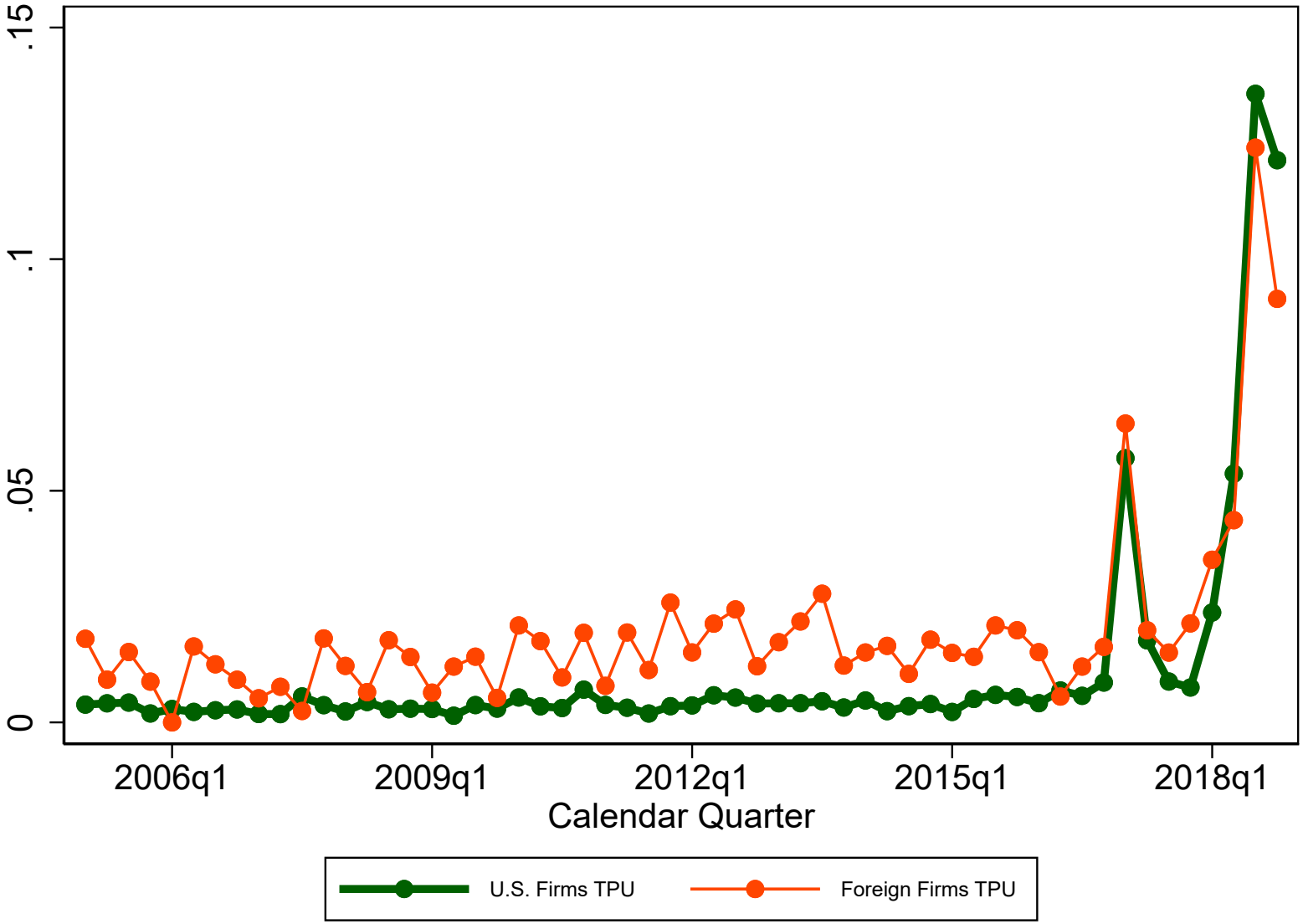
US vs. Foreign Firms TPU



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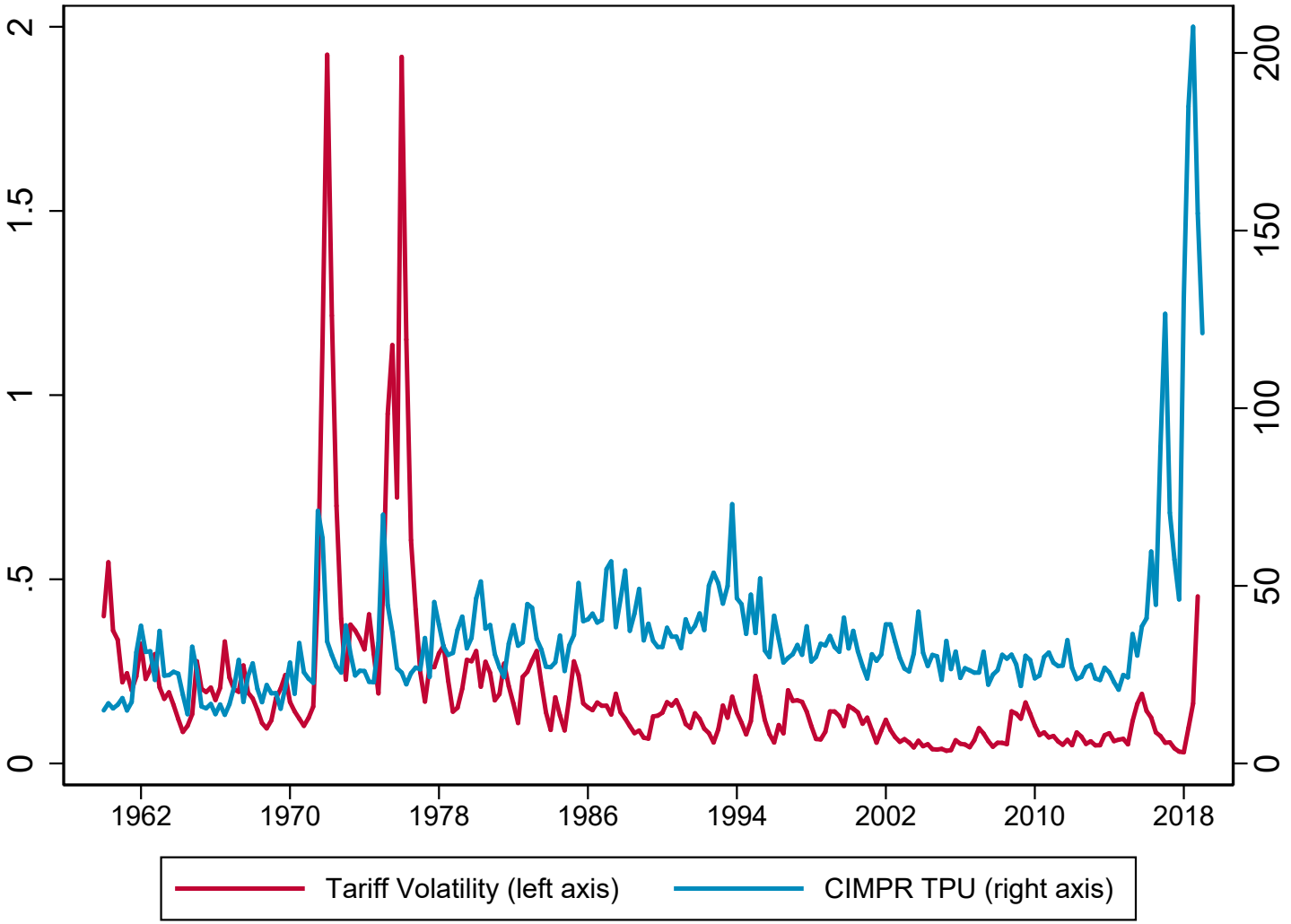
News-Based vs. Tariff Volatility TPU



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Correlation of tariff volatility with other shocks

External Shocks	Correlation	(p-value)	Granger F-test	(p-value)
Oil shocks[a]	−0.08	(0.45)	0.65	(0.52)
Monetary policy shocks[b]	−0.05	(0.70)	0.78	(0.46)
TFP growth shocks[c]	−0.01	(0.91)	0.07	(0.94)
Unanticipated tax shocks[d]	−0.00	(0.99)	0.19	(0.83)
Defense spending shocks[e]	0.06	(0.53)	0.95	(0.39)
Capital tax vol. shocks[f]	0.14	(0.28)	1.04	(0.36)

NOTE: The entries in the table denote the pairwise correlations and Granger-causality tests between the tariff volatility shock identified under the baseline VAR specification and a set of external instruments. The regressions underlying the pairwise Granger causality tests include a constant and two lags of each external instrument. Sample period for the volatility shocks is 1960:Q3 to 1984:Q4.

[a] Crude oil supply shock from Hamilton (2003).

[b] Monetary policy shocks from Romer and Romer (2004); (1969:Q1–1984:Q4).

[c] Residuals from a first-order autoregressive model of the log-difference in the utilization-adjusted total factor productivity; see Fernald (2012).

[d] Unanticipated tax shocks from Mertens and Ravn (2011).

[e] Defense spending news shocks from Ramey (2011).

[f] Capital tax volatility shocks from Fernandez-Villaverde et al. (2015).

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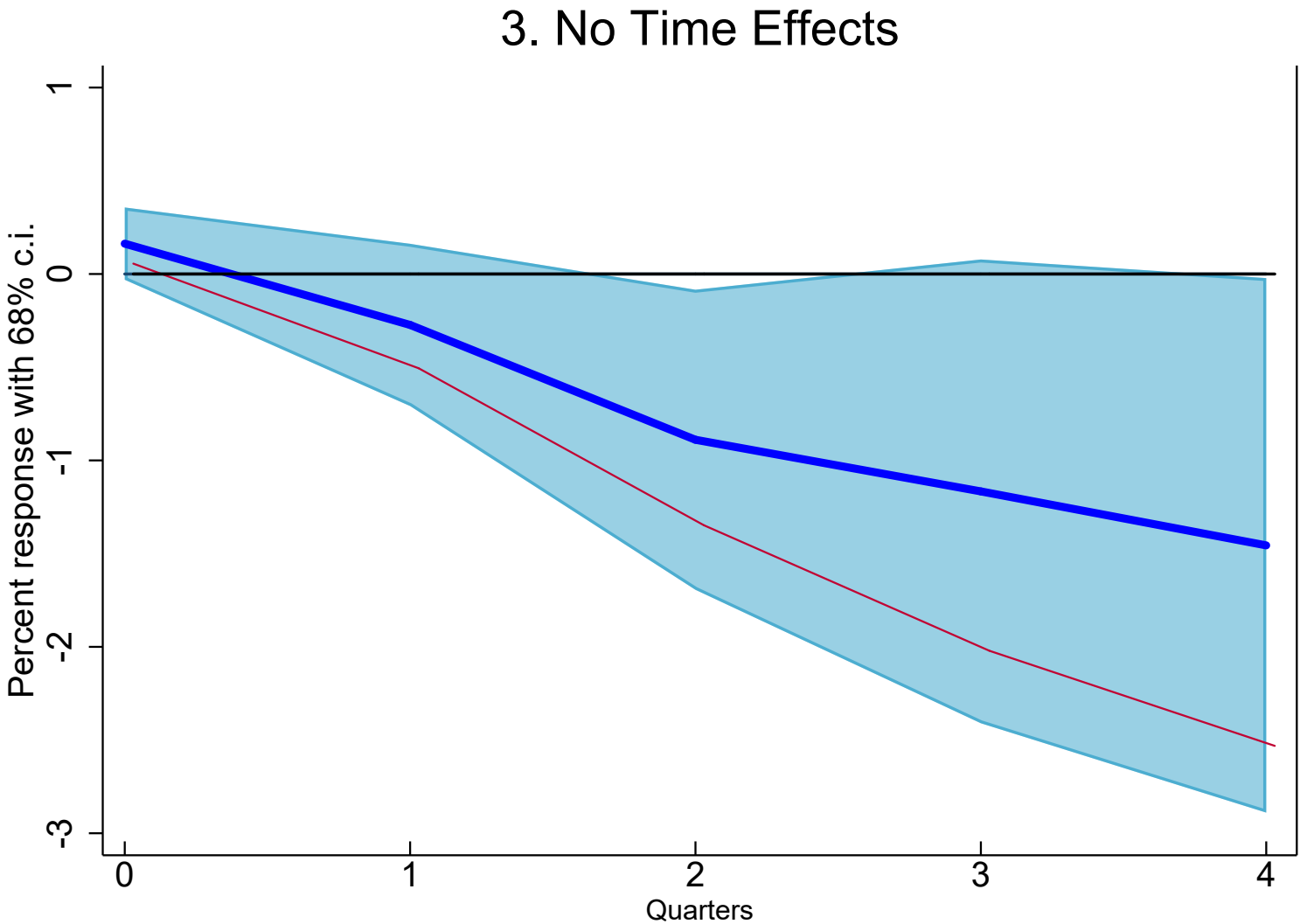
Local Projections: Robustness



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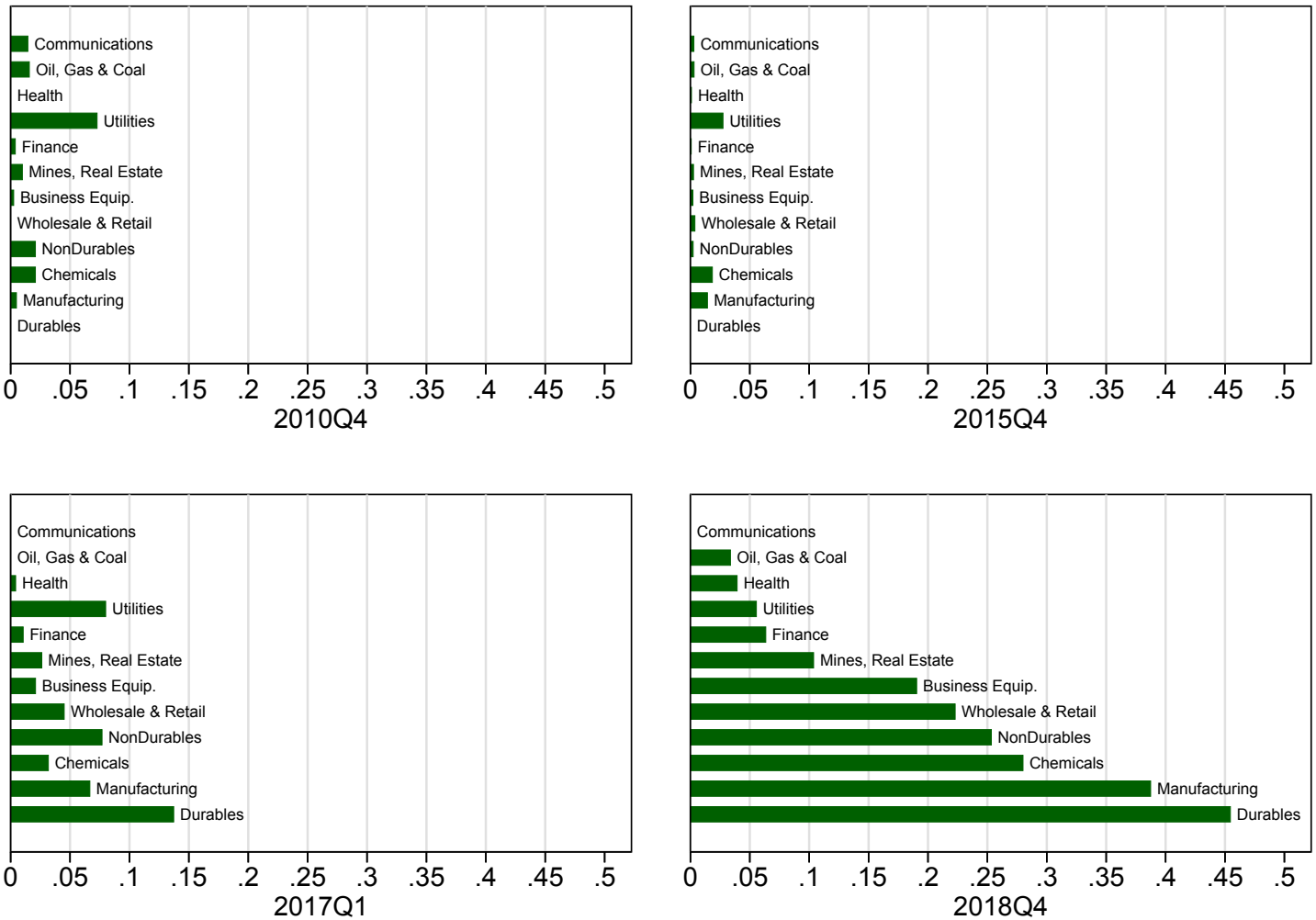


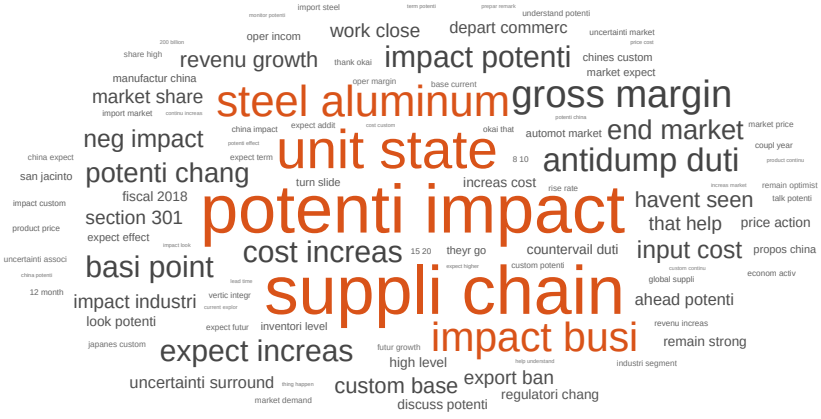
Note: Share of firms in the industry mentioning TPU in their earnings calls

Comparison with Hassan et al. (2016)

Topics List in Earnings Calls

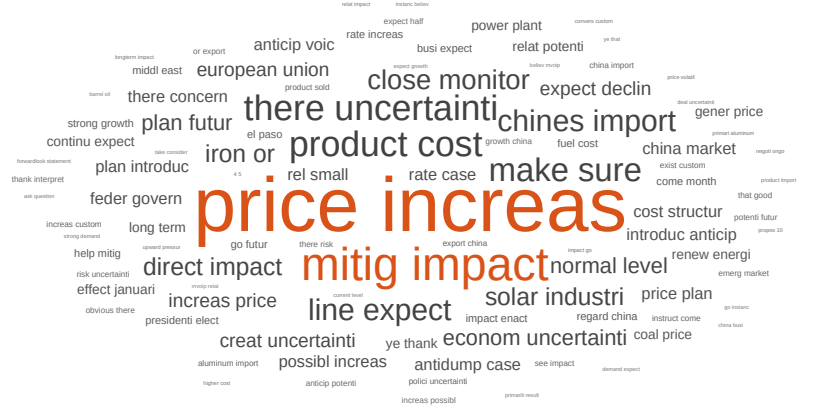
Topic 1

Topic 2



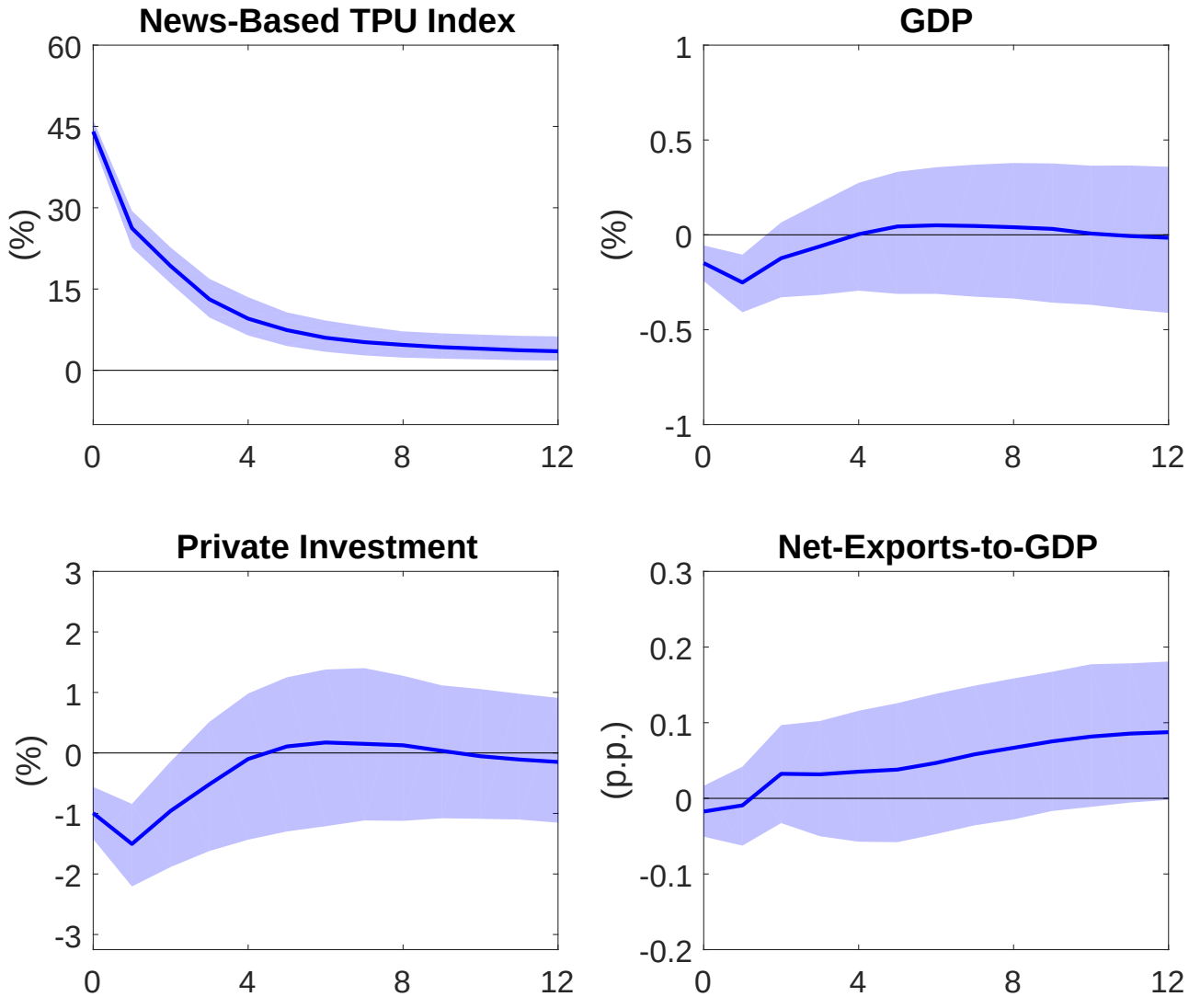
Topic 3

Topic 4



Note: LDA Analysis on Transcripts from All Years. Most Common Bigrams, Grouped by Topic.

VAR with News-Based TPU: 1960-2018



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TPU:

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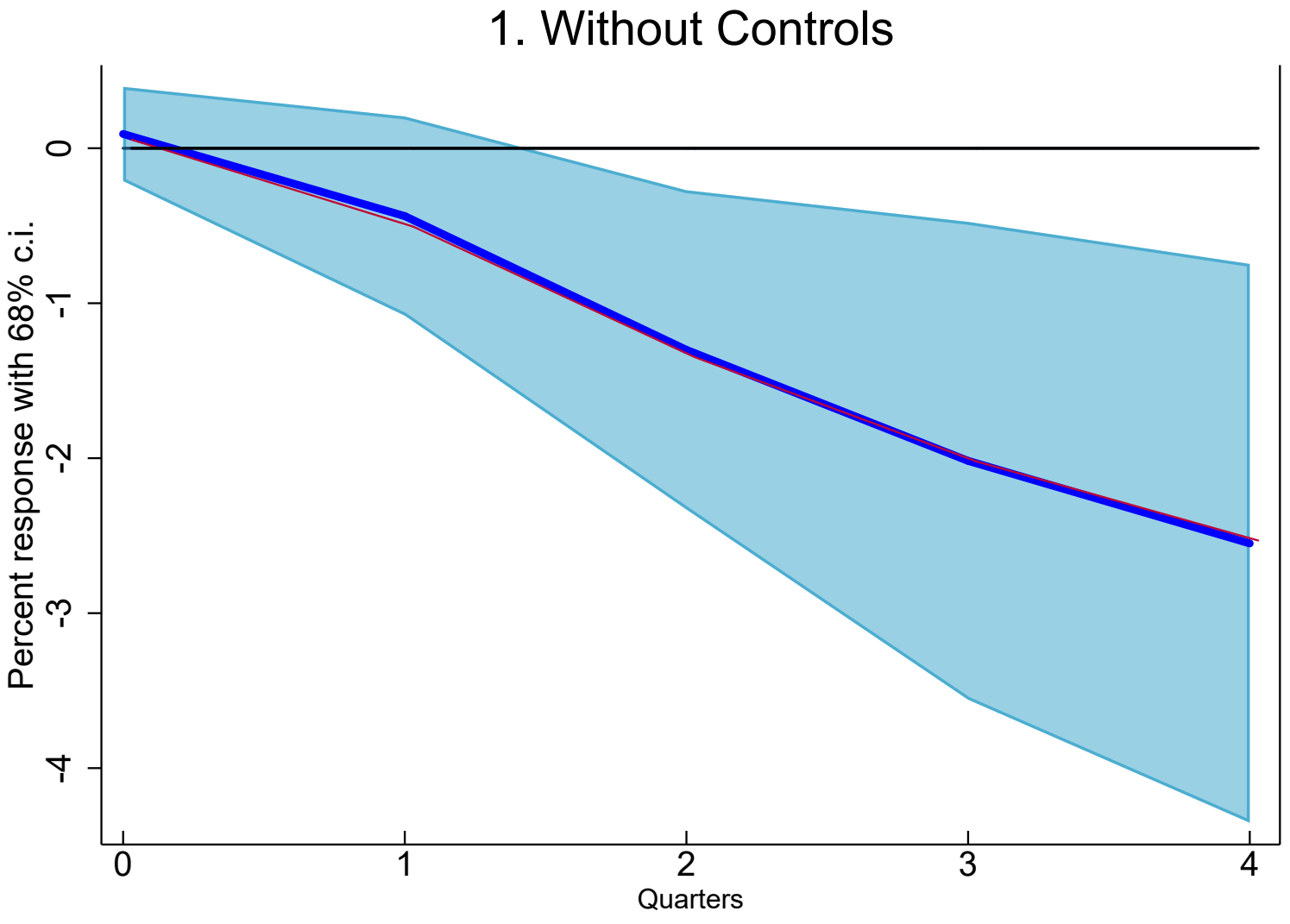

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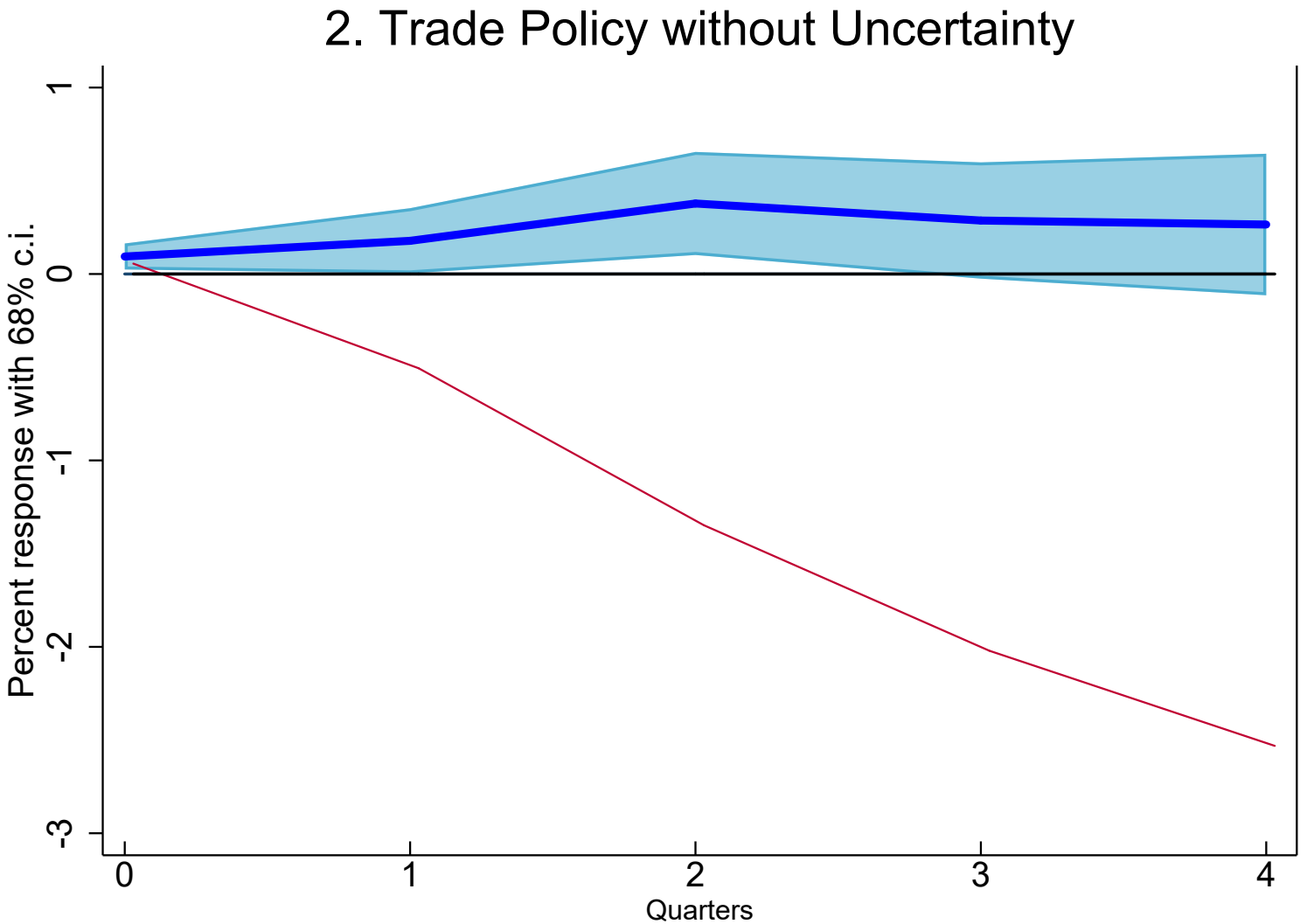
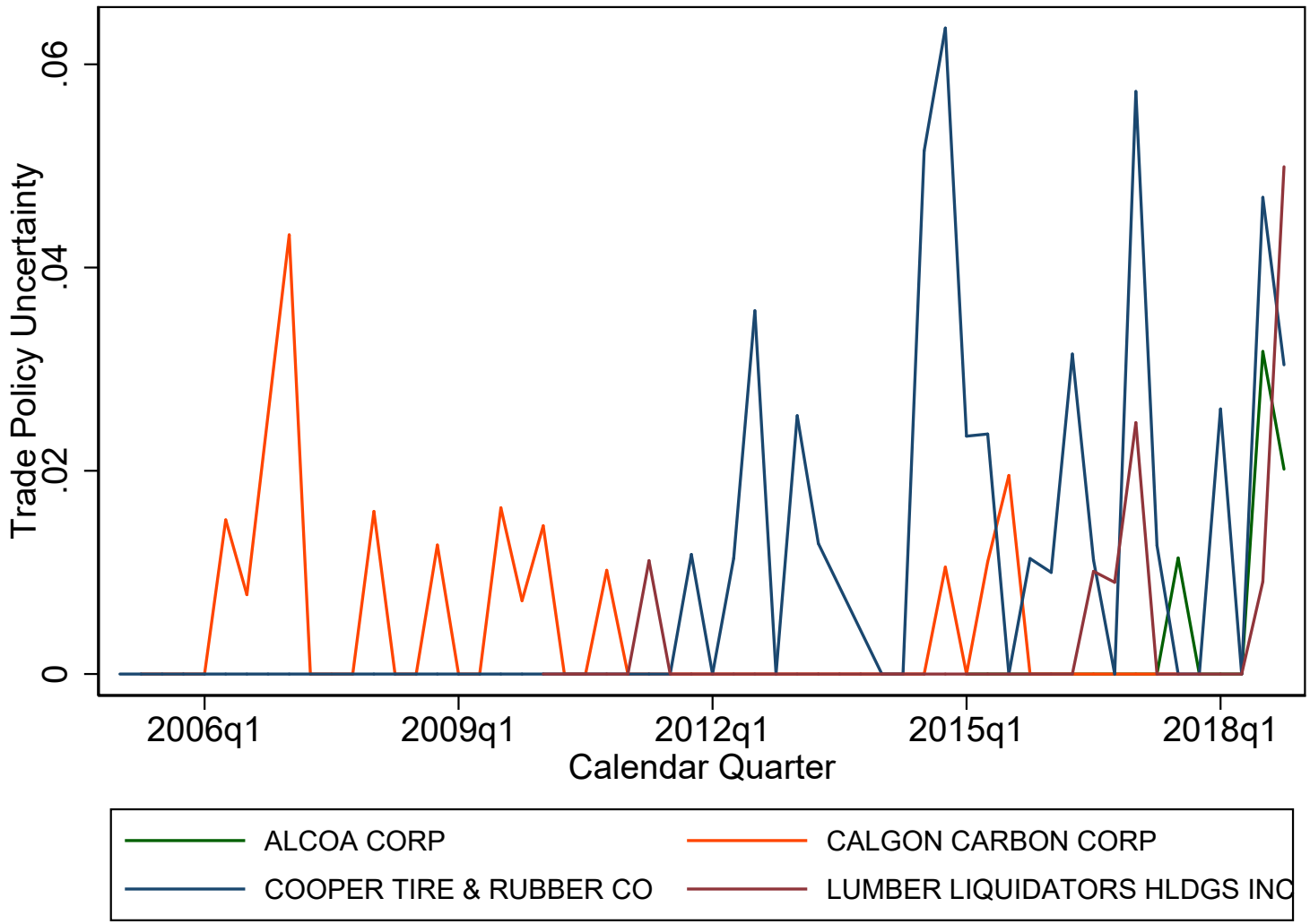


Additional Robustness (no Time Effects)

Measuring Firm-Level TPU: Variation Across Firms and Time



Note: TPU for selected firms.

Effects of Tariffs: Demand-Switching

Back

- Tariffs increase the relative price of imported goods $\rightarrow$ consumers switch towards domestic varieties

$$\underset{\text{imports}}{m_t} = \underset{\substack{\text{trade}\\ \text{elasticity}}}{-\theta} \times \underset{\substack{\text{price of}\\ \text{imports}}}{(p_{m,t} + \tau_t^m)} + \underset{\substack{\text{domestic}\\ \text{absorption}}}{a_t}$$

- This effect tends to boost domestic output but
  - Symmetric retaliation abroad reduces foreign demand
  - Supply-side distortions reduce domestic production

Effects of Tariffs: Supply-Side Distortions

Back

- Price of consumption bundle is $P\left(P_D, P_M, \underset{+}{\tau_t^m}\right)$
- Tariffs reduce relative price of domestic good

$$PROFITS = \frac{P_D}{P\left(P_D, P_M, \underset{+}{\tau_t^m}\right)} Y - r^k K - wL$$

- Tariffs are akin to a uniform increase in taxes on K and L

$$PROFITS = \frac{P_D}{P\left(P_D, P_M, 0\right)} Y - r^k \left(1 + \tau^k\right) K - w \left(1 + \tau^L\right) L$$

$\rightarrow$ Contractionary effect on investment and output

Effects of Tariffs: Firm Entry

Back

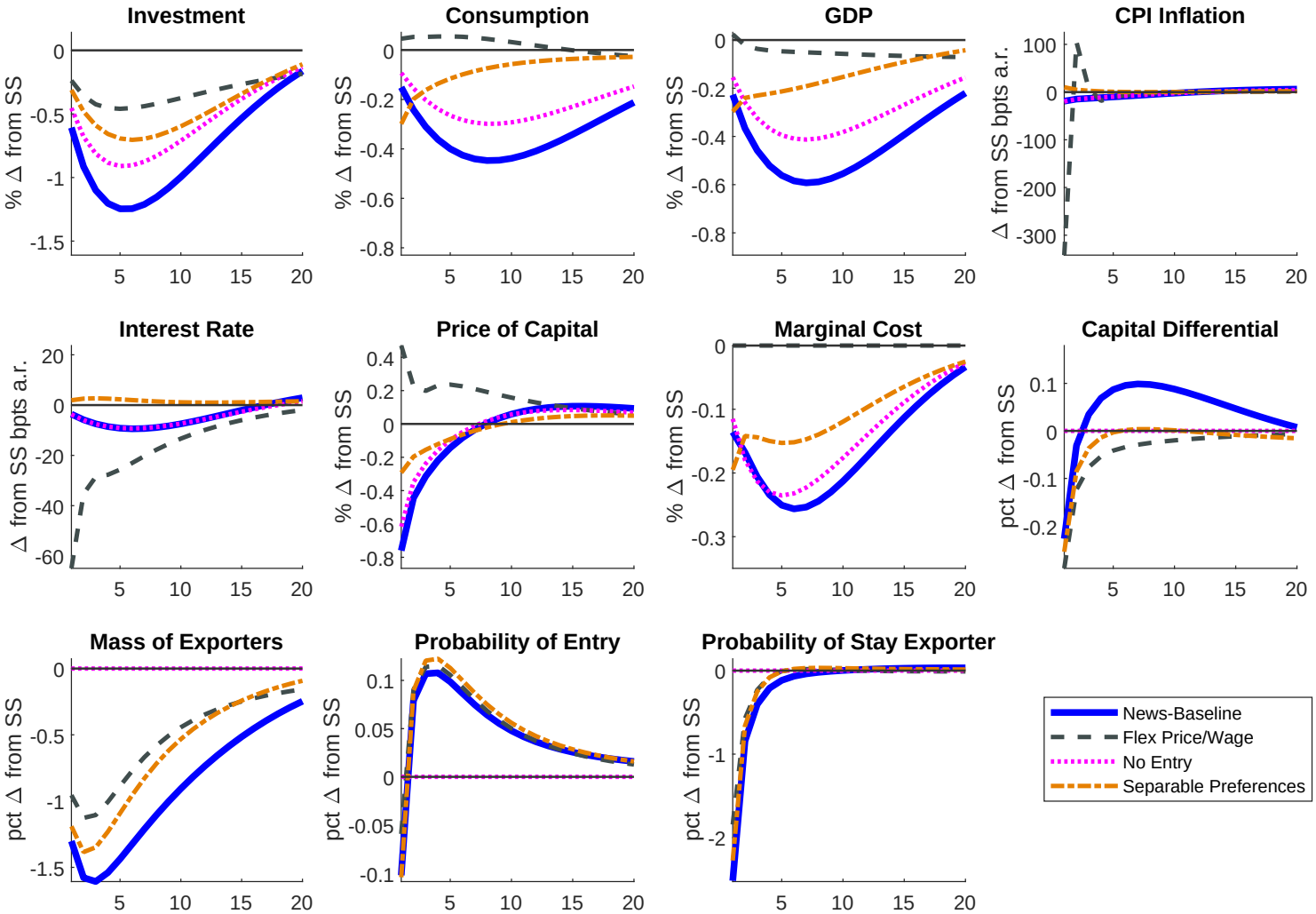
- Firm exports at t if productivity is above threshold z_m^*

$$\underbrace{p^k \Delta k}_{\substack{\textit{extra} \\ \textit{investment}}} + \underbrace{W_t c_m}_{\substack{\textit{fixed} \\ \textit{cost}}} = \underbrace{z_m^{*\gamma}}_{\textit{threshold}} \underbrace{\pi\left(W_t, K_{mt}\right)}_{\substack{\textit{unit} \\ \textit{profit}}} \underbrace{\left(\Gamma^{\nu}_{\text{exp}} - \Gamma^{\nu}_{no\,\text{exp}}\right)}_{\substack{\text{market size} \\ \textit{gain}}} + \underbrace{E\Delta V}_{\substack{\textit{gain} \text{ in} \\ \textit{contin.} \text{ value}}}$$

  where $m \in \{$ Exporter at t-1 , Non Exporter at t-1 $\}$

- Gain in market size $\left(\Gamma^{\nu}_{\text{exp}} - \Gamma^{\nu}_{no\,\text{exp}}\right)$ shrinks because of demand switching at home and abroad
- $\rightarrow$ Thresholds z_m^* declines and so Entry declines and exit increases
- Aggregate productivity declines as cross-sectional correlation between output and idiosyncratic productivity declines

Model Experiment 1: Results



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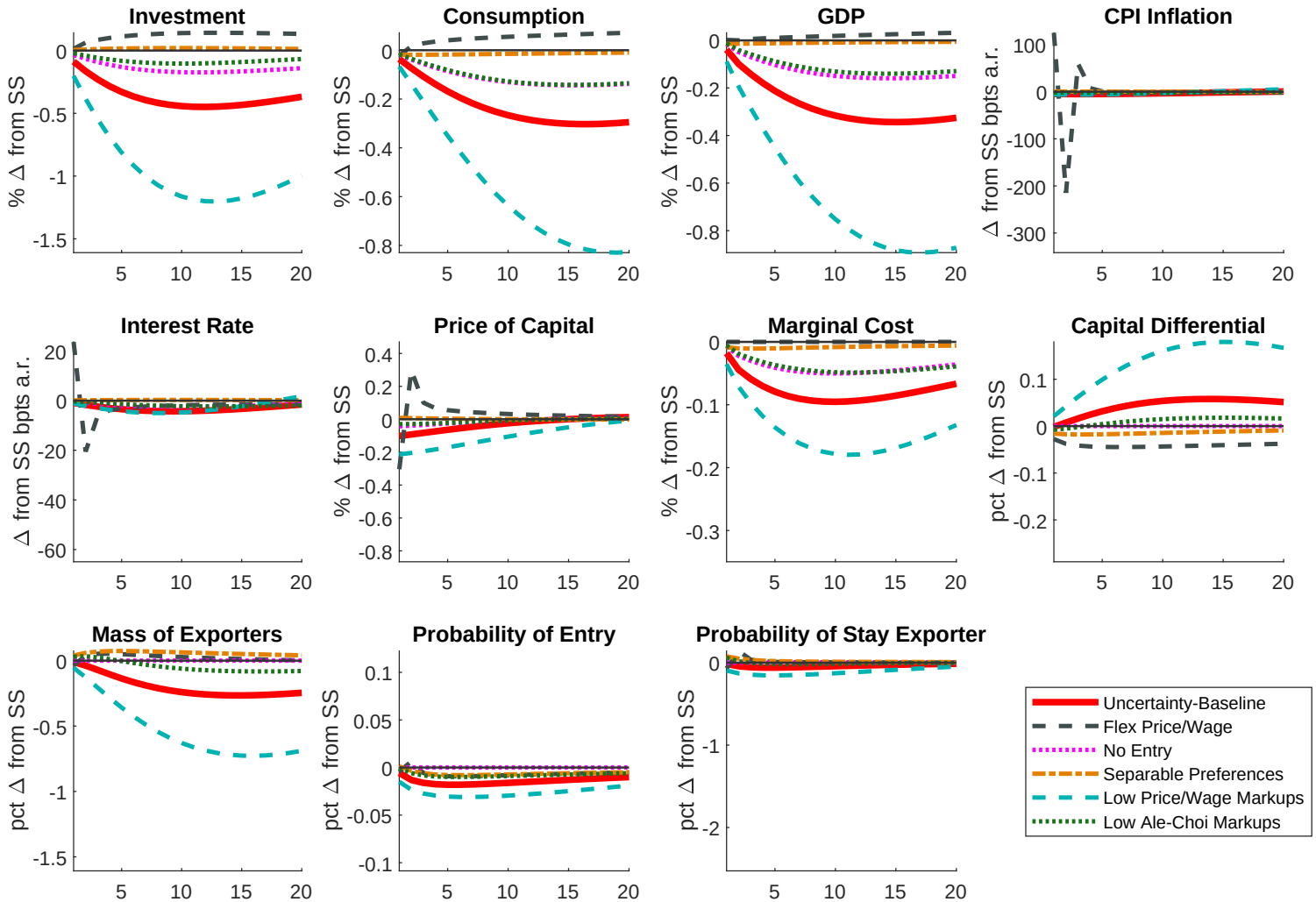
Model Experiment 1: Results



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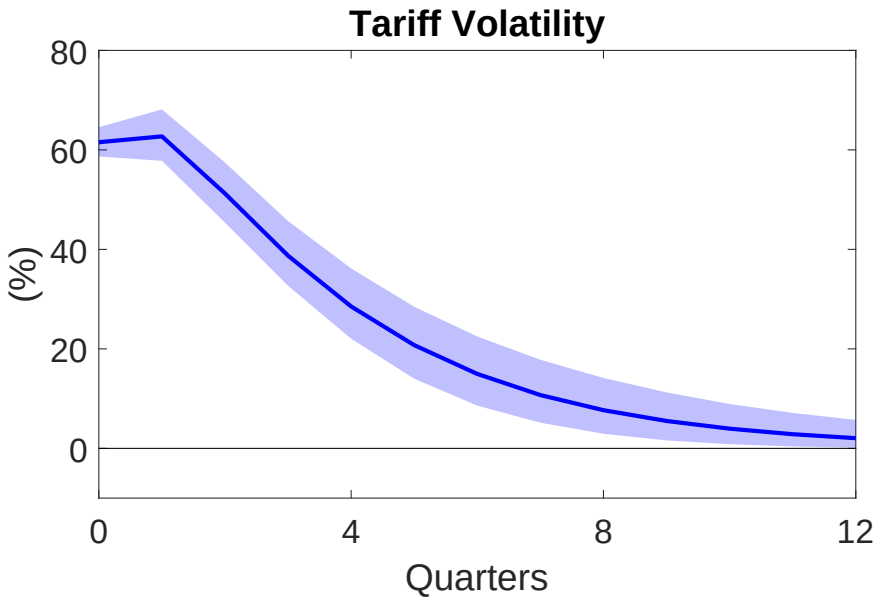
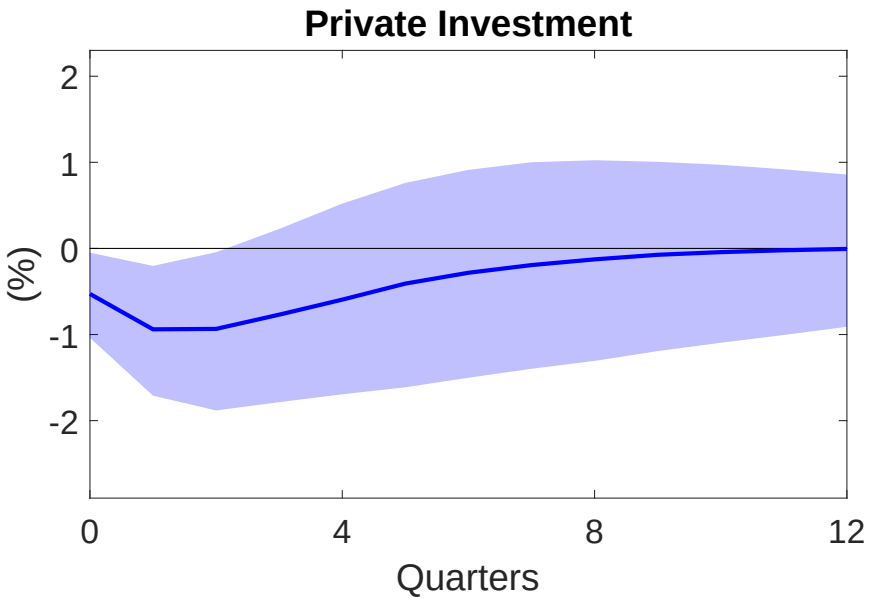
Aggregate Effects: Stochastic Volatility TPU





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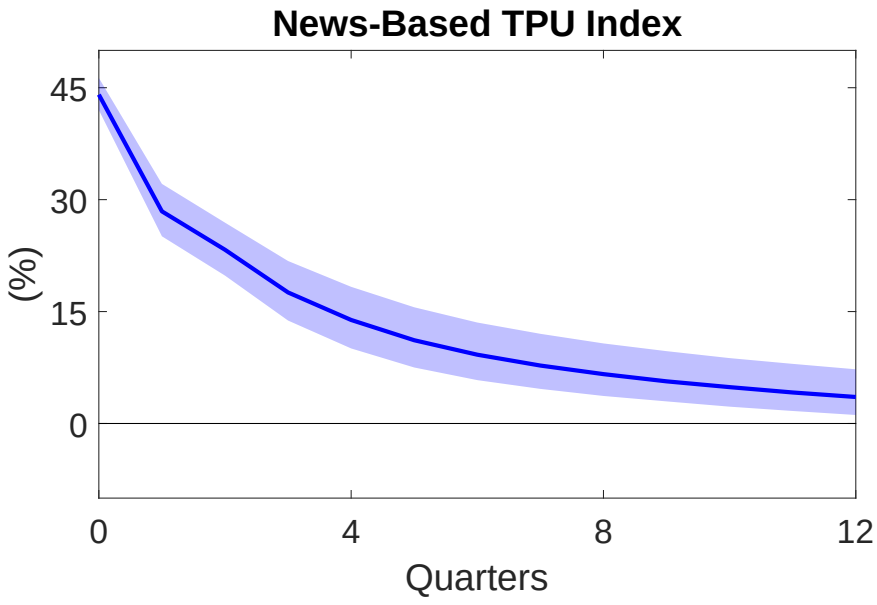
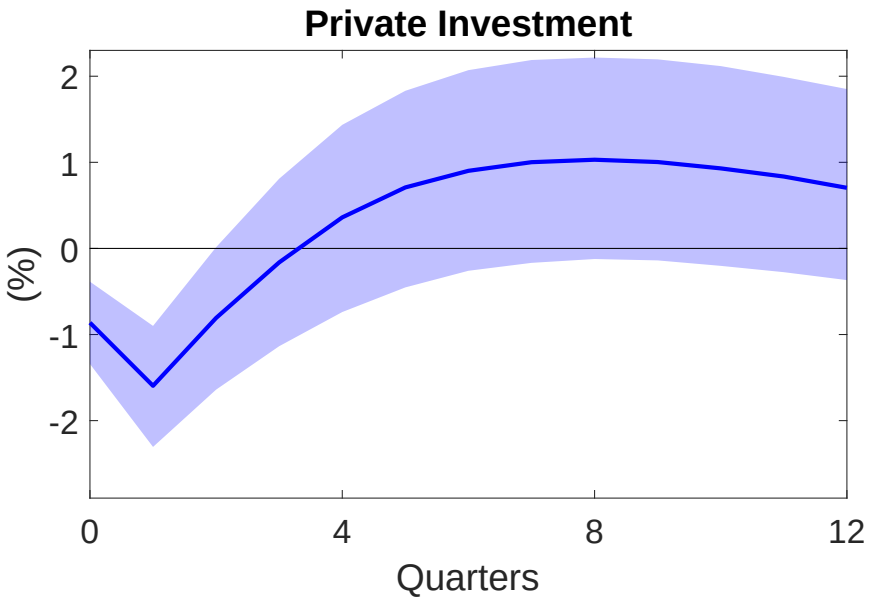
Aggregate Effects: Additional Controls





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