

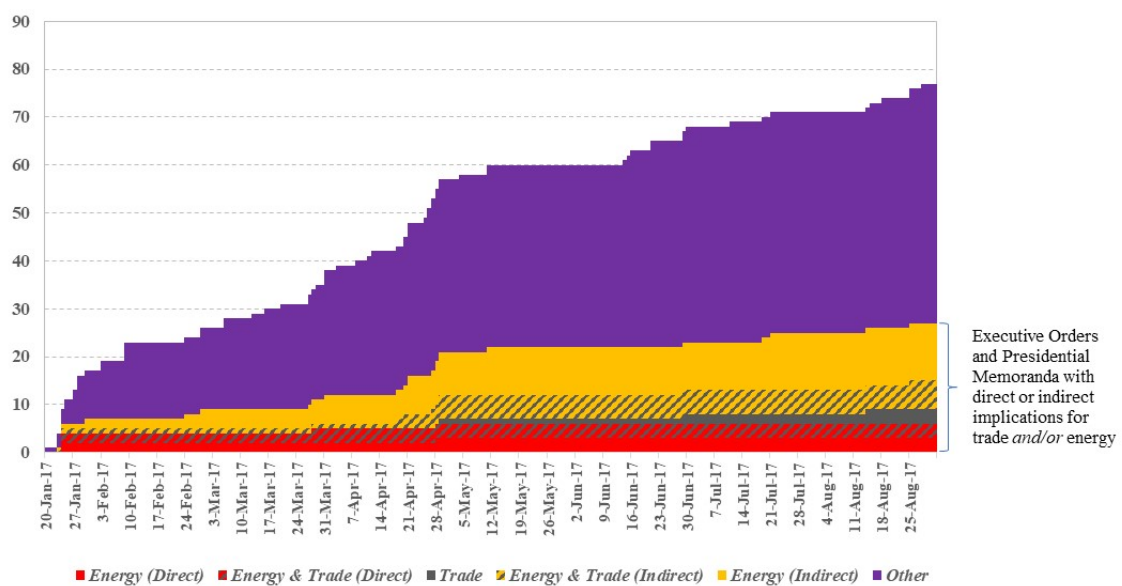
# The Trump Administration, Trade and Energy

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## Introduction

Since President Trump's inauguration, the Administration has been very active. As of August 28, 2017, the Administration had authored 45 Executive Orders and 32 Presidential Memoranda, some with implications for trade, energy markets and energy market participants.<sup>1</sup> A large proportion of these were not directed at energy or trade (see Fig. 1), a point that reflects the sweeping changes that the Trump Administration has attempted to usher into effect. But, the potential for Trump to impact energy markets and international trade have been the subject of much discussion, and uncertainty abounds.

**Fig. 1 A Timeline of Change – Executive Orders and Presidential Memoranda**



Source: Data indicated do not include Presidential determinations, proclamations, notices and sequestration orders. Data are compiled from the *Federal Register*, which is published by the Office of the Federal Register and is publicly available; Classifications are based on author's own analysis

The subject of international trade took a heightened emphasis in the run-up to the 2016 Presidential election. A key part of the campaign discussion was existing and potential free trade

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<sup>1</sup> For comparison, by the same date following being elected into office, President Barack Obama authored 22 Executive Orders and 46 Presidential Memoranda. President Obama ultimately authored 275 Executive Orders and 644 Presidential Memoranda during his entire term in office.

agreements to which the US is, or could be, a signatory, with the Trans-Pacific Partnership (TPP) and the North American Free Trade Agreement (NAFTA) taking center stage. Then candidate Trump promised to renegotiate trade agreements to secure better deals for the United States, which included reducing bilateral trade deficits, promoting domestic production of various goods (and increasing domestic employment), and supporting export-oriented enterprise. Indeed, much of what was said on the campaign trail left many with the impression that the Trump Administration would pursue a mercantilist agenda.

**Fig. 2 US Trade Balance, January 1995 through July 2017**



Source: U.S. Federal Reserve Database online at the Federal Reserve Bank of St. Louis. The data series “Trade Balance: Goods and Services, Balance of Payments Basis, Millions of Dollars, Monthly, Seasonally Adjusted” is available at <https://fred.stlouisfed.org>.

## Mercantilism?

Mercantilism is the theory that trade generates wealth and is stimulated by the accumulation of surpluses (profitable trade balances), which a government should encourage through protectionist policies. When corporations, politicians, and special interests demand control over imports through higher-duties to protect local jobs and industries, they are resorting to mercantilism. Put simply, trade deficits are not good and governments should take steps to encourage surpluses. The US has generally run monthly deficits in excess of \$40 billion for the past several years (see Fig. 2), which equates to *annual* deficits in excess of \$500 billion. This is up considerably since 1997 when monthly deficits were around \$10 billion, so Trump’s rhetoric has some gravity for his supporters.

It should be noted that rapidly growing GDP in the late 1990s followed by the dramatic movements in oil prices through 2010 have strong explanatory significance over the observed changes in the trade balance, particularly because US oil import dependence did not begin to significantly decline due to the shale revolution until after 2008. Nevertheless, the existence of

negative trade balances and relatively meager economic growth over the past decade are two undeniable facts. Moreover, while it may be true that correlation is not causation, the perception that the US is losing out to foreign manufacturing is real, and perception *is* reality, especially in politics. Some examples that indicated the Trump Administration may push for a mercantilist agenda were...

- the promise to renegotiate NAFTA,
- threats to impose import tariffs and destination-based taxes, including the recently discussed Border Adjustment Tax (BAT),
- the formal withdrawal from Trans-Pacific Partnership (TPP), and
- an indicated preference toward bilateral trade negotiations.

We now discuss each of these issues in varying detail before some concluding remarks.

## NAFTA

The Trump Administration's push to open renegotiations of NAFTA should come as no surprise. In fact, a significant portion of Trump's constituency, particularly in the Rust Belt (the area spanning southern Wisconsin, the Great Lakes region, Ohio, and western New York that is so-named since the 1980s due to its declining industrial base), wants action due to the perception that NAFTA has contributed to the region's economic decline. Indeed, the thought that tougher trade agreements could revitalize certain parts of the US manufacturing base is central to this sentiment.

Within the first 100 days of the Trump Administration's time in office, U.S. Department of Commerce Secretary Wilbur Ross promised NAFTA was at the top of his list for review. Then, on July 17, the Office of the United States Trade Representative released a document titled: *Summary of Objectives for the NAFTA Renegotiation*. The document's stated goals for the renegotiation are to secure access for American exports and investment, to ensure competition by reducing subsidies and other market distortions in other countries, and to reduce the US trade deficit. Whether or not these goals are mutually compatible is uncertain, particularly because more open trade could cause the trade deficit to expand. At the time of this writing, the NAFTA discussions are ongoing.

On the energy front, NAFTA has helped integrate the North American energy market. US trade with Canada and Mexico in energy commodities currently exceeds \$140 billion annually, and last year the US had an energy trade surplus with Mexico of more than \$11 billion. Mexico is currently the recipient of the majority of US natural gas exports and these volumes are expected to increase further in the coming years as new pipeline infrastructure is completed. Notably, the *Summary of Objectives for the NAFTA Renegotiation* calls to, "Preserve and strengthen investment, market access, and state-owned enterprise disciplines benefitting energy production and transmission and support North American energy security and independence, while promoting continuing energy market-opening reforms." It also calls for strong and enforceable environmental provisions to be part of the core of the Agreement.

Beyond this, however, the Summary offers few specifics about the energy component of the NAFTA renegotiation. The United States continues to import oil and gas from Canada, so there

seems to be little scope for renegotiating energy-related NAFTA provisions with Canada. Mexico's energy sector, on the other hand, has historically been subject to inefficiencies associated with state-owned monopolies, although reforms have opened Mexico to private investment since 2013. So, renegotiating NAFTA to more explicitly account for energy given the recent reform in Mexico is arguably needed. In fact, the continued openness of the Mexican energy sector and the increased access by foreign corporations might benefit from renegotiation. While it is a controversial topic in Mexico, increased access to Mexican resources could be beneficial for all involved, as it could increase competition throughout North America. Indeed, if sufficient assurances about reform and continual access were to become an official part of a renegotiated NAFTA, this would create a commitment that the reforms will not be reversed in the future, which would send a strong signal to potential investors thereby creating opportunities for US-based firms in the oil and gas supply chain.

In the end, there is still significant uncertainty about what a renegotiation will bring, and the implications would be much broader than just energy. Nevertheless, there are some things that can be highlighted with regard to the energy sector specifically.

- If NAFTA remains intact, cross-border natural gas export infrastructure will continue to be “rubber stamped” as it will not be subject to a national interest determination by the U.S. Department of Energy. Any abolition of NAFTA would jeopardize future exports by subjecting them to study prior to being sanctioned.
- NAFTA could also have implications for the cost of delivering Canadian and Mexican heavy crude oils to the complex refineries in the US Gulf Coast that are designed to process these crudes. A renegotiated NAFTA could create advantages for Canadian and Mexican crudes versus other international crudes if an import tariff is levied on those supplies.
- NAFTA could also affect joint development opportunities in the Gulf of Mexico. If NAFTA renegotiations were unsuccessful, US Gulf Coast-sourced equipment and services for the offshore Gulf of Mexico (GoM) would be disadvantaged. This would be exacerbated if Mexico responded by enforcing stricter local content requirements for Mexican GoM developments. Not only would this slow the pace of development in the Mexican offshore longer term, it would also reduce the economic benefit that would otherwise be realized in the US. Both outcomes compromise North American energy security.

In short, renegotiating NAFTA, particularly with regard to energy where the slate is relatively blank, could avoid repercussions that would compromise US export capabilities. Ironically, this means, at least for energy, abolition of NAFTA or unsuccessful renegotiations presents an anti-mercantilist outcome by compromising the ability to export US oil and gas as well as the equipment and services associated with production south of the border.

## **Import Tariffs and Destination-based Taxes**

Import tariffs and destination-based taxes have also been floated as means to generate new government revenues, while promoting domestic manufacturing. The so-called “border adjustment

tax” (BAT) is a destination-based tax that was originally floated as part of a broader proposal to overhaul the US tax code, although it has ramifications for trade. This plus the continued threats from the Trump Administration for the use of tariffs on imported goods has cast a lingering shadow over the future of international trade for one of the world’s largest importers.

While import tariffs and destination-based taxes are generally viewed as protectionist measures, the BAT gained traction as a means to generate new revenues to replace those lost as a result of a proposed reduction in the corporate tax rate. The plan, as originally discussed, suggests a 20% tax rate in imported goods. Everything sold in the U.S., domestic or imported, gets taxed (including intermediate goods – parts and materials that are imported – are also taxed), but revenue from exports is not taxed. So, companies would be taxed based on point of sale. In principle, the BAT would encourage domestic production because offshoring is no longer as attractive. It would also encourage exports by providing domestic manufacturers an advantage in foreign markets because they won’t pay a tax on foreign sales. The BAT is comparable to, but not exactly like, a value-added tax (VAT), which is where businesses pay sales tax on the value added as goods are produced along the supply chain. Many nations already use a VAT, particularly in Europe, rather than rely on income taxes like in the US.

Mechanically, a BAT is relatively easy to understand, but its implications for energy markets and trade are not. Many analyses suggest a hike in gasoline prices domestically, a rise in WTI, and an advantage to US coal, oil and gas exports. But, these analyses often tend to be overly-simplistic and suffer from short-comings that convey dramatic impacts on energy markets. These works tend to...

- ignore the issue of tax incidence,
- make unrealistic assumptions about the relative elasticities of supply and demand for crude oil and petroleum products,
- ignore heterogeneity in crudes (i.e. – heavy crude is not light crude), and
- give no attention to broader macroeconomic drivers.

Some review has been done of past shifts in trade policies in other countries (see, for example, TaxFoundation.org), and the predicted dire consequences of various proposed policies prior to the changes are generally not realized. However, the proposed shifts in trade and tax policy in the US have no real analog, so better analysis is needed.

For crude oil markets, to determine the impact of a BAT it is important to recognize that the US has already eliminated its imports of light crudes due to the dramatic increase in domestic light crude production. However, it still imports heavy and medium crudes. So, attempting to focus any analysis on WTI can be misleading. The implications of a BAT for crude oil prices in the US and abroad, as well as petroleum product prices, will be determined by the prevalence of non-US destination opportunities for foreign heavy and medium crude oil producers, substitution opportunities across crudes for domestic refiners, and the cost of the barrel at the margin for petroleum product sales.

For natural gas markets, exports will look more profitable relative to domestic use. But, the impact on domestic price will depend on the elasticity of domestic supply, and the elasticity of domestic and foreign demand. The relative elasticities of supply and demand will determine who –

consumers or producers – bears the burden of a destination-based tax. Moreover, understanding how an accompanying reduction in the corporate income tax rate impacts the profitability of production is critical to a full assessment of how cost and price will change. For example, a lower corporate tax rate will lower the marginal cost of development, but it is not yet clear how this moves the overall domestic supply curve relative to a BAT. In sum, the answer is more complicated than a simple *ceteris paribus* analysis might indicate.

Aside from any critiques of analysis of a BAT that can be levied, there is an issue of its legality and political feasibility. A VAT, which is widely used and accepted by the World Trade Organization (WTO), is an indirect tax. A BAT would be implemented as a direct tax. While this is a technical issue, it almost certainly would be a subject of discord among nations party to the WTO.

### **The TPP and Bilateral Trade Relationships**

The Trans-Pacific Partnership is a 5000+ page document that was negotiated by the Obama Administration with governments around the Pacific Basin, but it was not ratified. In fact, President Obama announced he would not move forward with it near the end of his term, effectively leaving its fate up to the Trump Administration. As one of his first acts, President Trump signed on January 23, 2017 and published in the Federal Register 2 days later the Presidential Memoranda “Withdrawal of the United States from the Trans-Pacific Partnership Negotiations and Agreement” (see Fig. 3), which formally abandoned the TPP. Moreover, the Administration’s intent to approach trade relationships in a bilateral manner was emphasized.

**Fig. 3 Excerpt from Presidential Memorandum Concerning the TPP  
(82 FR 8497, Document #2017-01845)**

#### **Memorandum for the United States Trade Representative**

It is the policy of my Administration to represent the American people and their financial well-being in all negotiations, particularly the American worker, and to create fair and economically beneficial trade deals that serve their interests. Additionally, in order to ensure these outcomes, it is the intention of my Administration to deal directly with individual countries on a one-on-one (or bilateral) basis in negotiating future trade deals. Trade with other nations is, and always will be, of paramount importance to my Administration and to me, as President of the United States.

Based on these principles, and by the authority vested in me as President by the Constitution and the laws of the United States of America, I hereby direct you to withdraw the United States as a signatory to the Trans-Pacific Partnership (TPP), to permanently withdraw the United States from TPP negotiations, and to begin pursuing, wherever possible, bilateral trade negotiations to promote American industry, protect American workers, and raise American wages.

You are directed to provide written notification to the Parties and to the Depository of the TPP, as appropriate, that the United States withdraws as a signatory of the TPP and withdraws from the TPP negotiating process.

Source: The full text can be obtained from the *Federal Register* (82 FR 8497, Document #2017-01845).

Hence, a mercantilist approach to future US trade negotiations appears to have some founding. But, the shape that such negotiations take has yet to be realized, so there remains considerable uncertainty about what it all means.

### **Closing Remarks: What does all this mean?**

It is difficult to postulate how the Administration's approach to international trade will actually play out, and, hence, how it will impact energy markets. Nevertheless, a mercantilist approach to trade policy will present barriers to international trade by raising costs, which could be exacerbated if trade wars emerge.

Any policy or set of policies that raises barriers to trade will not bode well for US energy security. Unfettered trade enhances fungibility and allows short term disruptions to be arbitrated quickly and efficiently. Anything that disrupts this will ultimately limit market responsiveness and convey costs that would not otherwise exist. This is precisely why deeper markets enhance energy security. But, market depth can be compromised if policy becomes burdensome for new investments, capital inflows and market participation. Of course, nothing is black and white, and the extent to which the Trump Administration's trade policies may compromise energy security is likely a shade of gray. One simply hopes it remains on the lighter side of the spectrum.

This said, it is important not to engineer dramatic outcomes. Rather, a measured approach that considers the relative elasticities and appropriate incidence of various measures on consumers and producers is needed. In addition, the inter-relation between different measures needs to be considered, for example, when considering the independent and co-dependent impacts of shifts in NAFTA, the adoption of a BAT and other bilateral trade policy measures. In the end, any shift in US trade policy will impact energy markets, and will likely induce a reshuffling of trade flows. But, the long run implications are likely to be mediated by overall global fungibility.

Regarding NAFTA, the picture for the future remains unclear, but there is a concerted effort being undertaken to renegotiate the trade agreement. Commerce Secretary Ross recently stated that the end of 2017 is a natural point of reference to determine if NAFTA renegotiations will be successful, citing impending elections in 2018 as natural stalling points. If a deal cannot be struck, he was quoted as stating that withdrawal from NAFTA "would be the right thing to do." This position reiterates statements made by President Trump. So, how do we assess these remarks? Are these statements merely a negotiating tactic? A natural starting place is the *Summary of Objectives for the NAFTA Renegotiation* published on July 17. That document lays out a fairly open approach to trade, albeit with domestic interests clearly highlighted. So, if those objectives are met, then perhaps the worst case will not come to pass. However, it remains to be seen whether the goals of both avoiding barriers to trade while at the same time improving the US trade balance are mutually compatible.

Looking more globally, it is unlikely that the Trump Administration will take steps to limit access by foreign countries to US energy exports. It is more likely that the Administration will take steps to facilitate energy exports. This will carry spillover benefits for global energy markets and

enhance energy security more broadly. However, if trade policy becomes restrictive in other dimensions – solar panels, steel, etc. – one wonders what the ramifications may be for US exports of oil and gas. The last thing an increasingly globalized economy needs less than a decade removed from one of the deepest recessions in history is a trade war.

#### Writer's Profile

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He directs the Masters of Energy Economics Program at Rice University, where he also holds adjunct professor appointments in the Department of Economics and the Department of Civil and Environmental Engineering. Dr. Medlock is a principal in the development of the Rice World Natural Gas Trade Model, which is aimed at assessing the future of international natural gas trade. He is an active member of American Association for the Advancement of Science (AAAS), American Economic Association (AEA), and International Association for Energy Economics (IAEE). He received his Ph.D. in economics from Rice University in May 2000.