

Trade War: Two elephants in a porcelain shop

ALEXEY KRAVCHENKO* AND MIA MIKIC*

“...how far it is proper to continue free importation of certain foreign goods...when some foreign nation restrains by high duties or prohibitions importation of some of our [s]...Revenge in this case naturally dictates retaliation...Nations accordingly seldom fail to retaliate in the manner. There may be good policy in retaliations of this kind, when there is a probability that they will procure the repeal of the high duties or prohibitions complained of...When there is no probability that any such repeal can be procured, it seems a bad method of compensating the injury done to certain classes of our people, to do another injury ourselves, not only to those classes, but to almost all the other classes of them.”

(Adam Smith, 1776, pp.434-435)

Highlights

- The imposition of import tariffs on steel and other metals is not new for the United States, but tying it to “national security” reasons is somewhat of a novelty. As the sector has been struggling with international competitiveness for many decades, there is scepticisms that an import duty of 25 per cent will make much difference. Especially as 65 per cent of steel and aluminium imported from seven major exporters into the United States got exempted from paying this duty.
- China – accounting for only 3 per cent of imports of United States steel and 16 per cent of aluminium, not only did not get exempted but got additionally threatened with a hefty 25 per cent tariff on about \$200 billion worth of exports (and counting). These added punitive tariffs – in addition to (erroneously) thinking that they will reduce bilateral China-US trade deficit - were to incentivize China to abandon what the United States and others see as unfair trade practices not the least in area of intellectual property protection. Instead, China decided to join in this tit-for-tat, targeting first only \$3 billion and then raising it to over \$50 billion of the most sensitive American exports to China. Both countries have also filed a complaint at the WTO leaving some hope for the WTO’s Dispute Settlement Mechanism to show (again) its worth.
- So far, no tariffs were put into force, but the apprehension of that happening and escalating into a full-blown trade war is highest in the recent history (in Google search metric). ESCAP simulated impacts of such global trade war confirming that no party engaged in the war gains. However, there is a real danger of high collateral damage, not only in terms of economic losses to other countries, but also irreparable harm to the multilateral trade system. The key message coming from this is that there are no winners in trade wars.

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Steel and aluminium tariffs

On 8 March 2018 the United States President signed an order to impose a 25 and 10 per cent tariffs on imports of steel and aluminium, respectively. Imposition of tariffs on steel imports is not new to the United States.¹ The special protection of steel sector was ever present, with almost every administration leaving its own mark.² Most recently, in 2016 the Obama administration imposed 500 per cent plus import duties on selected steel imports from China, and in 2002 the Bush administration imposed import duties of up to 30 per cent on key steel products. As of 31 December 2017, the United States had a total of 167 trade remedies in effect affecting steel mill imports (International Trade Administration, 2018). What raised much deeper concerns through the trade community, however, is the rationale cited for the imposition of tariffs. Whereas previous protectionist measures were explicitly linked to safeguarding domestic industries or retaliating against unfair dumping, the argument this time was national security. The legal basis lies in section 232 of the United States Trade Expansion Act of 1962, which since commencement saw only seven successful investigations that found imports threatened or impaired national security, with Presidents subsequently taking any action (Bureau of Industry and Security Office of Technology Evaluation, 2007).³

The General Agreement on Tariffs and Trade 1994 (“GATT 1994”) allows the WTO members to take security and defence policy measures that would be exempted from the general legal obligations. This exception to the GATT 1994 rules is contained in Article XXI, titled “Security Exceptions”. Article XXI is the most powerful exception to the general obligations undertaken by WTO members. This Article has been used very rarely since 1947 and the provisions of Article XXI have never been subjected to Dispute Settlement Mechanism.⁴ Given that the United States military requirements for steel and aluminium account for only 3 per cent of the local production (Secretary of Defense, 2017), the move leaves the United States open to the retaliatory actions, especially as “national security” rationale remained unchallenged through the Dispute Settlement Mechanism of the WTO.

There are rarely good economic arguments for use of import tariffs, particularly if looking beyond a narrow sectoral/group protectionist interest. Indeed, Bush-era tariffs, which lasted for only 21 months, while linked to an increase of 3,500 in steel industry employment came at a staggering cost of \$400,000 per job (Peterson Institute for International Economics, 2003). The currently proposed tariffs are also likely to result in job losses in sectors depending on competitively priced steel and aluminium, such as carmakers or soft drinks. The 2002 tariffs have been estimated to have caused a loss of 200,000 of such jobs (Francois and Baughman, 2003).

A scramble for exemptions and a return to managed trade

The new tariffs on steel and aluminium, as well as other protectionist measures invoked, announced or threatened, should be seen as the continuation of the administration’s unorthodox negotiating tactics that started with a withdrawal from the Trans Pacific Partnership agreement in January 2017 while promising much “better” deals to be negotiated bilaterally. It appears that the approach to negotiation of these deals

¹ In fact, the first step in this tit-for-tat was the United States President’s approval of a 30 percent tariff on solar panels and a 20 percent tariff on washing machines with sending a heavy blow to exporters in China and the Republic of Korea.

² Alexander Hamilton endorsed steel tariffs back in 1789 (Irwin, 20014), and after Hawley-Smoot tariffs were abolished, steel got defended by Lyndon B. Johnson, Jimmy Carter, Ronald Reagan, George H.W. Bush, George W. Bush and Barrack Obama.

³ Five out of seven were oil-related, including oil import embargos from Libya and the Islamic Republic of Iran, and establishment of various fees on oil imports, some of which were subsequently deemed illegal and/or removed.

⁴ In case of a dispute between United States of America and Nicaragua, where the United States had imposed trade embargo on Nicaragua; the panel was not allowed to examine or judge the validity or motivation for the invocation of Article XXI.

is to start by unilaterally improvising protection and then removing it in a selective fashion, based on concessions captured by those (cornered) individual negotiating parties. Indeed, already 65 per cent⁵ of imported steel gotten excluded from paying these new tariffs and 55 per cent of imported aluminium, after imports from Canada, Mexico, the European Union, Australia, Republic of Korea, Brazil, and Argentina were excluded subsequent to the tariff announcement.

To gain exemptions, Republic of Korea agreed to renegotiate its free trade agreement with the United States to expand import quota for cars and extend phasing out of some tariffs, while separately promising to restrain steel exports by 70 per cent of their recent levels (Financial Times, 2010). This effectively re-introduced voluntary export restraint arrangements (part of the so-called era of “managed trade” at its peak in the 1980s) into the trade rules after they were banned in 2002 by the WTO. Similarly, Australia has reached a “security agreement” to qualify for an exemption. The European Union was quickly added to the exclusion list when it threatened to impose retaliatory tariffs on iconic American products, such as orange juice, Bourbon whisky, blue jeans, and Harley Davidson motorcycles. In contrast, China, whose exports of steel and aluminium to the United States accounts for just over 3 per cent of imported steel and 16 per cent of imported aluminium, did not get any exclusions. On the contrary, it is now feeling the full brunt of the administration’s protectionist crusade.

Is it all about trade deficit, after all?

In a broader context, it would appear that it is the bilateral trade imbalance with China which drives much of the recent trade policy of the United States. Current merchandise trade deficit of \$375 billion is “explained” by unfair trade, mainly associated with practices in technology transfer, use of intellectual property and innovation.⁶ Since steel trade with China (already subject to safeguard measures) is relatively small (see figure 1), the Trump administration announced separately tariffs on up to \$60 billion of imports from China on 22 March 2018, with an additional 25 per cent tariff on a list of 1,300 products worth \$50 billion on 3 April 2018.⁷ In response, China announced a proposed list of 128 products imported from the United States, valued at about \$3 billion as target for their “tit for tat” tariffs after the first set of measures were announced, followed by a further list of 106 products with import value of \$50 billion to face a 25 per cent tariff in retaliation for the second wave of tariffs. This was met with yet another \$100 billion threat from the United States. When this careless throwing of tariff threats started, it was hoped that like other strong-worded statements, these will too fizzle out with a behind-the-scenes negotiations. For example, when announcing the initial set of measures on March 22, 2018, the President of the United States stated, “*So we’ve spoken to China and we’re in the midst of a very large negotiation. We’ll see where it takes us. But in the meantime, we are sending a Section 301 action...*” (White House, 2018). China meanwhile filed a complaint at the WTO over the announcement of these tariffs and requested consultations with the United States under the WTO’s Dispute Settlement Mechanism claiming that the measures are inconsistent with trade rules at the WTO.⁸ If the negotiations are taking place, their effect is not noticeable at present. Not only that, but the rhetoric about the American economy and people losing through its large and persistent trade deficit is not weakening.

⁵ Based on 2016 trade values using UN Comtrade database (accessed March 2018), chapter 72 (iron and steel) and chapter 76 (aluminium and articles thereof).

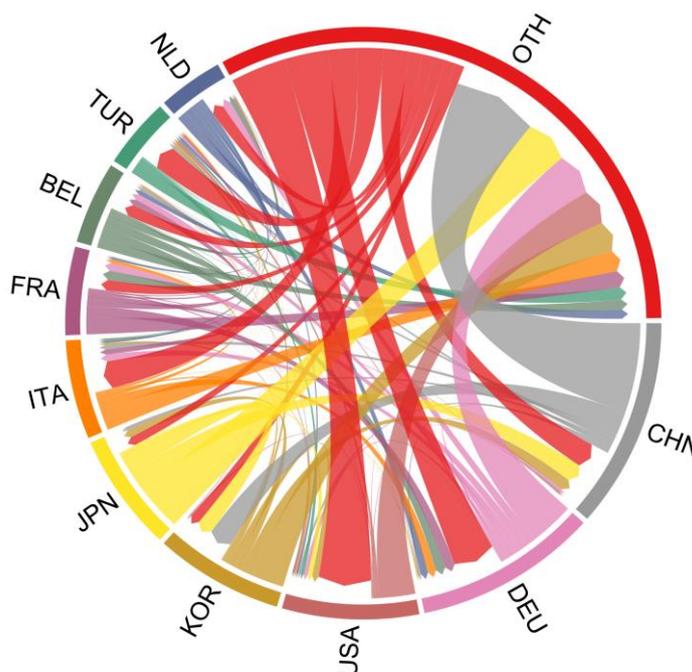
⁶ There is a general agreement in the global trade community that China should improve inter alia its handling of foreign IP protection, technology transfer issues related to foreign companies operating in China and some issues related to China’s industrial policy and operation of state owned enterprises.

⁷ This was the most recent announcement from the US side at the time of the writing of this commentary. The authors fear that by the time this will be read, there would be several more rounds of escalation.

⁸ According to the text of China’s request for consultation with the United States, these “proposed duties would be only applied to China’s products and in excess of the United States bound rates in its Schedule of Concessions and Commitments annexed to the GATT 1994.” and as such inconsistent with GATT Article I.1 and II.1 (a) and (b). See more details in WTO document WT/DS543/1G/L/1219.

United States does have a large merchandise trade deficit with China. However, trade in goods is only part of a country’s international transactions. In many countries, including the United States, trade in commercial services accounts for large part of international exchange. While bilateral services trade data is not readily available, data on overall balance in commercial services trade show that the United States in a net exporter of services, while China is a net importer (see Figure 2). Adding the surplus in services trade (\$250 billion) to the merchandise trade deficit (widely quoted \$800 billion), puts the deficit of the United States to below \$550 billion.

Figure 1. Global steel trade pattern, 2016



Source: ESCAP calculations using data from UN Comtrade database (accessed March 2018), Chapter 72 (Iron and steel) imports and mirror imports, 2016.

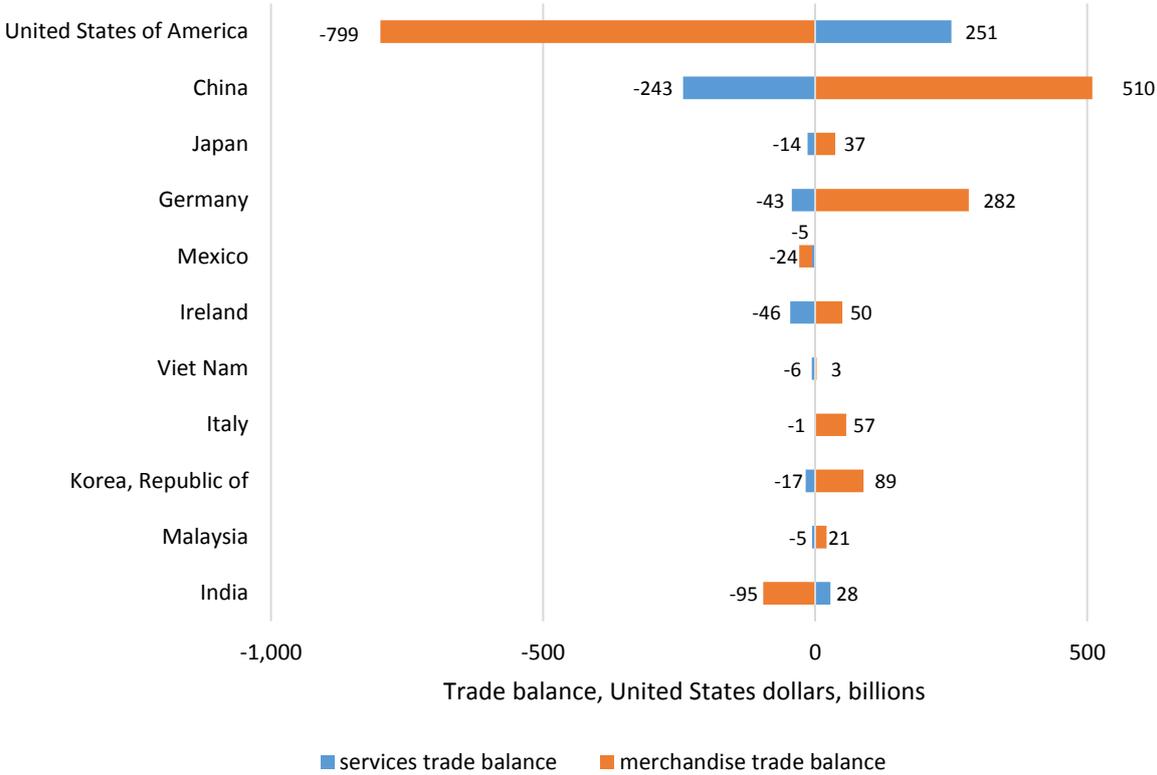
Note: NLD = Netherlands; TUR = Turkey; BEL = Belgium; FRA = France; ITA = Italy; JPN = Japan; KOR = Republic of Korea; USA = United States of America; DEU = Germany; CHN = China; OTH = others.

Large and persistent trade and current account deficits often invite blaming trade partners and their unfair and predatory trade practices; rarely a country running a current account deficit points to the causes in its own economy or policies. The United States are not unique in linking their current account deficit to the global trade rules and trading partners’ practices. However, it is worth pointing that, in principle, there is nothing wrong with running a deficit or a surplus with ones’ trading partners. While many books have been written about the cause and implications of trade or current account deficits, for the argument here there are two points worth noting – how current accounts are measured and what factors really drive the current account size and sign.

First, most of the reported trade balances are based on the gross commercial value of cross-border flows of goods and services. These gross value flows do not capture the complex nature of global trade today where countries often import intermediate goods and services for adding value locally before (re)exporting. Adjusting by value-added flows reveals a significant reduction in bilateral trade deficit between developed and developing countries, including between China and the United States.⁹

⁹ For example, it has been estimated that China adds only 4 per cent of to the overall value of an iPhone manufacturing, with components (including from the Unites States) coming from elsewhere, whereas the full import value of each iPhone is recorded in trade balance. When adjusting for the global-value added, the US-China trade deficit is lowered by approximately a third.

Figure 2. Merchandise and services trade balances of the United States and its 10 trade partners (with whom the United states runs the largest bilateral merchandise trade deficits), 2016



Source: ESCAP calculation using data from WTO Trade Statistics, 2018

Second, current account deficit may not indicate competitiveness levels, but a low level of national savings relative to investment. This means the current account deficit can happen either in a country that is highly productive and rapidly growing or in a country with a mismanagement of fiscal policy or over consumption. The savings-investment imbalance implies that the deficit is unlikely to respond to protectionist policies because there is no obvious connection between protectionism and savings or investment. In fact, the deficit can be desirable or undesirable for a country at a particular point in time depending on factors underlying the trend.

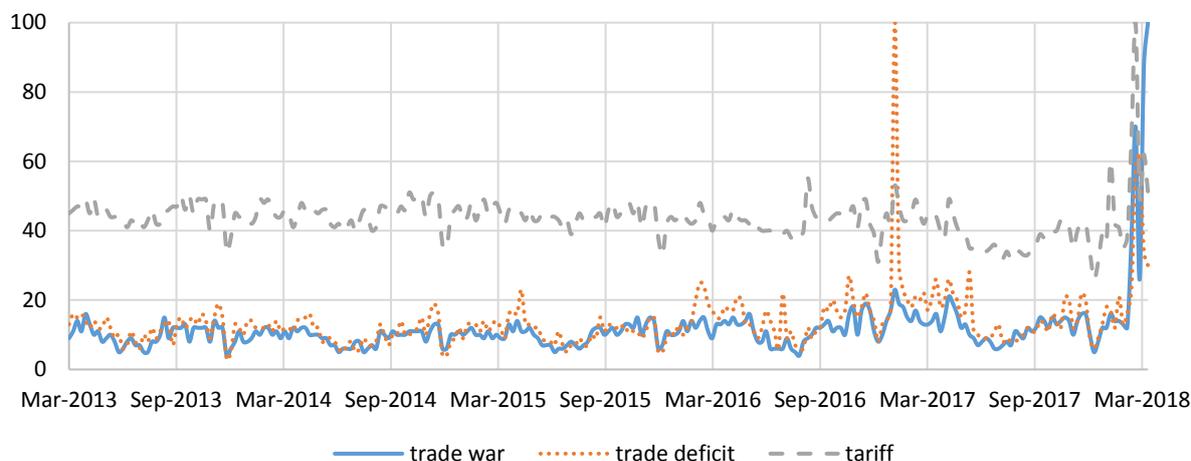
Instead of focusing on the bilateral balance, it is more constructive from a policy perspective to realize that the United States’ exports to China have been steadily increasing since 2000s, while the exports to the United States from China have reached their peak in early 2000s and have since plateaued.

A global trade war has no winners

In light of recent escalation in tit-for-tat protectionist actions, the risk of a renewed wave of further trade protectionism is heightened. The widespread apprehension and concerns about possible fallouts from a looming trade war in reflected in an explosion of Google searches for terms “trade war”, “tariff” or “trade deficit”. March 2018 saw a flurry in Google searches for trade-related terms (see figure 3). Significantly, the search for term “trade war” has increased five-fold above the five-year average. The term “trade deficit”, seemingly followed the pattern of search of “trade war”, except the spike on 26 January 2017, when President Trump tweeted, “The U.S. has a \$60 billion trade deficit with Mexico. It has been a one-sided deal from the beginning of NAFTA with massive numbers of jobs and companies lost. If Mexico is unwilling to pay for the badly needed wall, then it would be better to cancel the upcoming meeting.”

Similarly, “tariffs” saw a doubling in interest above the five-year popularity trendline. These search trends point towards a growing concern among netizens about the current deterioration of the trade climate and erosion of economic prosperity.

Figure 3. World-wide searches of selected terms on Google, Mar 2013-Mar 2018.¹⁰



Source: ESCAP calculation based on data from Google, 2018 (accessed April 2018).

ESCAP secretariat is mandated to provide member States with solid inputs for evidence-based policy making. As international trade and investment continues to be a strong engine of prosperity in the region, policymakers are naturally concerned with possible fallout from a trade war between the two world’s largest trading economies. Therefore, a modelling exercise was undertaken to gauge impacts, especially on the countries which are not directly involved in this tit-for-tat. ESCAP (2017) modelled a global trade war, where the trade protectionist measures initiated by one or a few countries ultimately lead to other countries retaliating. Specifically, the simulation shows the effects of all countries raising import tariffs to their bound levels¹¹ globally between 2015 and 2030.¹² The tariff rates increase by each country will depend on their “policy space” – commonly also referred to as “water”¹³ in tariff protection, being a difference between applied and bound tariffs. The bound rates in certain countries remain considerably higher than their applied rates (see figure 4) indicating much larger room for manoeuvre with duty rates. WTO rules allow their members to maintain this buffer, giving policymakers opportunity to react in case of import surges by increasing applied rates without violating WTO commitments. The magnitude of policy space varies substantially between Asia-Pacific economies, with, for example, Hong Kong, China not having any at all and Bangladesh having more than 10 times its average applied tariff rate.

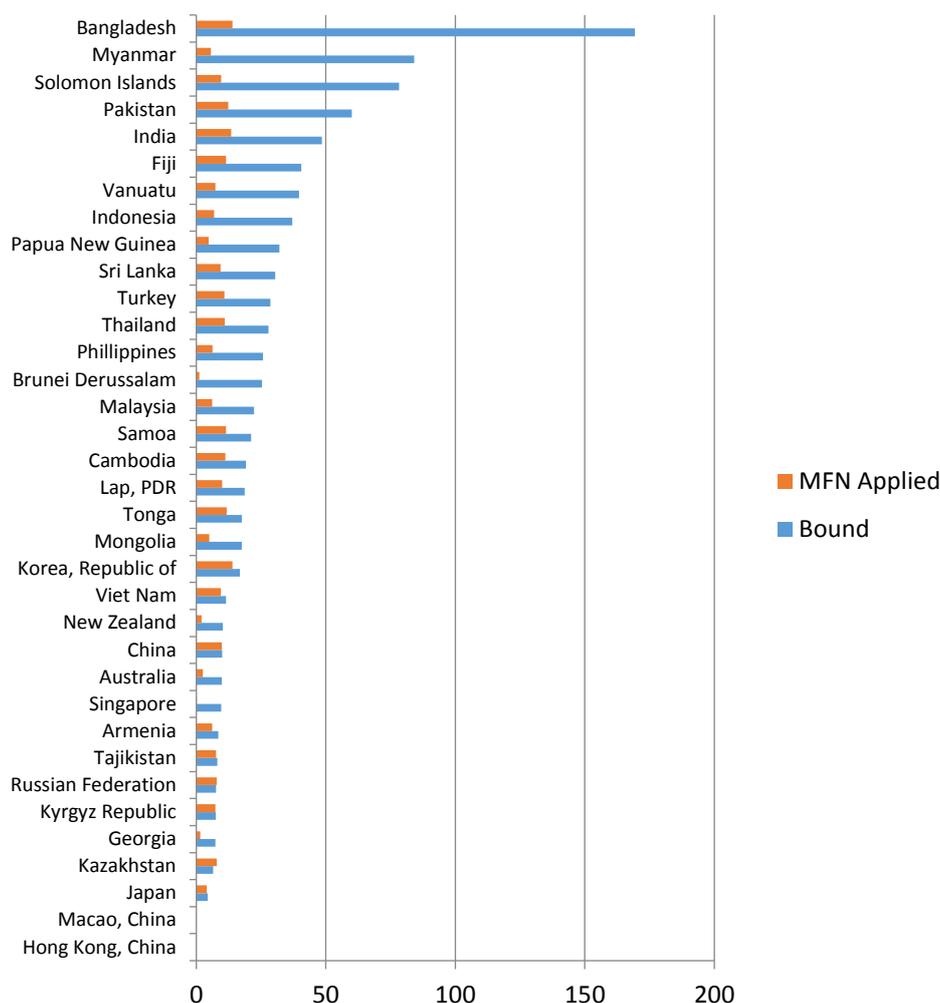
¹⁰ Numbers represent search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. See: <https://trends.google.com/trends/explore?date=today%205-y&q=trade%20war>

¹¹ Bound tariffs are maximum MFN duty for a given commodity line. They are incorporated as an integral component of a country's schedule of concessions or commitments to other World Trade Organization members.

¹² For the details on methodology please refer to ESCAP, 2017, pp.130-131.

¹³ Although, “water in the tariff” often refers to redundant protection, tariff rates higher than those that would drive imports to zero (so-called prohibitive tariffs).

Figure 4. Bound and applied MFN tariff rates in selected Asia-Pacific economies, all products, simple averages, latest year available



Source: ESCAP calculation using data from WTO Trade Statistics, 2016

Table 1 shows the overall impact of the WTO-consistent tariff hikes of all its members. Gross domestic product (GDP) falls in all world’s regions, varying annually between 0.2 per cent in Latin America to 0.9 per cent in Europe. This leads to an overall global reduction in GDP of \$380 billion a year, or a nearly \$5 trillion loss between 2018 and 2030. In comparison, the global net official development assistance and official aid in 2016 was just under \$160 billion (World Bank, 2016). This drastic reduction of global GDP is driven by trade contraction, as expected, with exports and imports both plummeting globally.

Asia-Pacific’s GDP decreases more than \$110 billion per year – amounting to a cumulated loss of \$1.3 trillion between 2018 and 2030. The North and Central Asia subregion suffers the most significant reduction in GDP of 0.7 per cent, or \$16 billion annually. In absolute terms, East Asia’s GDP decreases the most by over \$51 billion annually. The declines in GDP are directly caused by reduced trade, but there is significant variation across subregions. South Asia exports decline a dramatic 38 per cent annually, while West Asia and the Pacific exports decline by only 5 per cent a year on average. The difference in the effects is largely due to the export product mix, i.e. subregions that are most affected have exports that are more susceptible to being blocked by increases in applied rates. In terms of imports, the countries in West Asia and North and Central Asia have the most policy space (i.e. their applied tariff levels are much lower than their bound tariff rates), so imports in these subregion shrink the most, falling by more than 30 per cent.

Table 1. Results of an increase in tariffs up to their bound levels (percentage deviations from the baseline)

	GDP	Exports	Imports
Asia Pacific	-0.4	-19	-17
<i>East Asia</i>	-0.3	-13	-7
<i>South-East Asia</i>	-0.3	-25	-14
<i>South Asia</i>	-0.3	-38	-8
<i>West Asia</i>	-0.3	-5	-38
<i>North and Central Asia</i>	-0.7	-15	-31
<i>Pacific</i>	-0.4	-5	-5
Latin America	-0.2	-13	-22
Sub Saharan Africa	-0.7	-3	-27
Other Africa	-0.5	-6	-10
Europe	-0.9	-37	-16
North America	-0.3	-15	-26

Source: ESCAP calculations.

Parting shots for alternative actions

As in the real wars, often most affected are innocent bystanders, so-called “collateral damage”. With the tariffs and other protection, especially applied for non-economic reasons, in addition to producers /exporters of targeted goods and consumers/importers being directly impacted, there will be indirect harm inflicted, both through price and income effects. Furthermore, because of already mentioned nature of global trade occurring through global value chains, there will be a strong adverse impact of downstream producers. This effect will not be contained to countries directly involved in trade war but will spread to all downstream supplying countries. Thus, products exported from China to the United States contain large share of inputs from other countries (including from the United States). Similarly, companies operating in United States and exporting to China are not necessarily American companies. Financial Times (6 April 2018) reported a grave concern of German manufacturers about a fallout from US-China trade war. “The fear is that the tariffs threatened by the US and Chinese governments, if imposed, will have a massively disruptive effect on the entire complex web of global value chains, harming other nations not directly involved in the trade war.” For example, Daimler would be exposed as its largest exporting market from the US operations is China, and in general German carmakers operating in the United States would be twice as hard hit than the American car producers. Similarly, restricting imports of “Chinese goods” destined for American market would spill over to supply countries, especially South-East Asia, often disproportionately harshly. There might also be a positive impact on the third parties, as some economic activities will be changing locality to “obtain” different country of origin thus opening some new opportunities.¹⁴ In principle, the more highly integrated producers are into these regional and global supply chains, the harder they may be hit in a short run, as experienced in 2008-2009 global financial crisis. The integration into such supply chains and production networks is still the model of choice for

¹⁴ One can recall the experiences of such practice during the era of Multi-Fibre Arrangement (1974-2004), when most of developed countries imposed quotas on imports of textiles and clothing from competitive developing countries exporters. The quotas were particularly focused on China which eventuated in some production being relocated to other similarly competitive locations (i.e. mostly with low wages).

development for most developing countries in the region. If this trade war is not contained, the consequences will be both in terms of economic impacts (and wider), but also possibly in terms of development paradigms.

Does retaliation ever pay off? As hinted by Adam Smith citation at the top of the commentary, there may be such situations but there are hard to come by. It is hard to find a solid economic rationale for retaliation and trade war. Rather, arguments belong to the same league of “national security” range used to justify imposition of tariffs in the first place – including boosting national pride – and are driven by geostrategic, foreign policy motives. One is reminded of the aftermath of an elephant (in this case, two of them) roaming around in a porcelain shop (in this case, the shop being multilateral trade system).

Instead of engaging in trade wars, countries can choose from a number of more promising alternatives. For instance, it is important to stand by and for multilateral trade rules and use WTO’s Dispute Settlement Mechanism whenever possible. Thus, it is good news that both China and the United States have also lodged separate complaints with the WTO Dispute Settlement Mechanism. It is discouraging, however, that they so far have not shown serious intention to fully utilize the potential that approach offers. Next, instead of moving backwards into the world of “managed trade” by accepting to ‘voluntarily’ restrain exports or expand imports, countries should be turning to more seriously looking for multilateral solution to problems of overcapacity not only in steel but other areas or in competition. Finally, it is crucial to accept that the WTO needs an improvement in how it can respond to address new realities, and thus there is a need to adapt multilateral trade rules and procedures to ensure a resilient trading system.

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