A closer look

Trade tensions: how worried should we be?

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Overview

It should not be necessary to defend the benefits of international trade. Or to warn of the dangers of trade wars. More than two centuries of analysis and evidence have largely settled the matter, at least among the overwhelming majority of those who have studied the issue. But the siren song of protectionism never loses its dangerous allure. In fact, it is growing louder once again, part of a broader populist drumbeat resonating in many parts of the world, perhaps most ominously in the U.S.—the country that has led the post-WWII open, rules-based international order, and whose continued leadership is indispensable to its preservation. That's not to say the current system is without flaws, impervious to abuse, and perfect as it stands. Certain trade practices—China's handling of intellectual property and technology transfer, for example—likely do violate global norms and need to be remedied. But the response ought to be a combination of determined negotiation, preferably in coalition with other countries that have similar complaints, and use of the World Trade Organization (WTO) for adjudication—not going it alone by swinging the tariff axe, especially not against countries that are in comportment with established rules and might otherwise be allies in efforts to reform China's practices, not by pulling out of trade pacts like the TPP, which could have strengthened U.S. leverage in negotiations with China, and not by undermining the WTO. Certainly not by retreating into a protectionist shell.

Fortunately, we don't think things will get that bad. The measures taken by the U.S. so far, while ill-advised, are too small to have major macroeconomic repercussions, and even if they spark some inevitable retaliation, the situation is apt to fall far short of a full-blown trade war. It's even possible that U.S. actions could be a negotiating gambit that ultimately improves existing trade relationships—with China, Europe, and North American Free Trade Agreement (NAFTA) partners. After all, the NAFTA negotiations seem to be making progress, and the U.S. has softened the steel and aluminum tariffs by exempting more countries, some of whom might now be more willing to form a united front with the U.S. in negotiating remedies to China's abuses and in bringing these complaints to the WTO. Still, benign outcomes are far from certain. Even a modest rattling of trade sabers can have adverse consequences, akin to a negative supply shock that damages economic efficiency, pushing up prices while limiting production possibilities. And risks of greater escalation cannot be dismissed.

Why is trade so often under attack?

The benefits of international trade, while substantial in aggregate, are diffuse, spread broadly across the population as a whole, and often hard to identify, while those who lose out from trade, though small in number, are visible, typically uncompensated, and understandably vocal. What's more, it's easier to vilify trade than, say, labor-disrupting technology—though the latter has caused much more profound dislocation—because the marvels that technology enables make it hard to demonize without being considered a Luddite, whereas attacks against trade fit neatly within broader populist ideologies. Also, the lessons of history are too soon forgotten. The damage wrought by past protectionist measures (Smoot-Hawley, anyone?), and the collapse of the global trading system during the cataclysms of 1914-1945 have largely faded from memory, mercifully obscured by the peace and prosperity of the post-WWII era that has been enabled in no small measure by the open, rules-based global system—whose fruits have now largely been taken for granted.

So it's necessary once again to counter the tired shibboleths of the protectionists and restate the overwhelming case for trade.

The benefits of trade

International trade—like all consensual economic exchange—is mutually beneficial, not zero sum. All parties to an economic transaction must view it as in their interest or they wouldn't engage. That simple truth is often overlooked. From a macro perspective, trade improves efficiency and well-being by enabling countries to specialize where they have comparative advantage, expanding the production frontier. In that way, it is no different than technology or other forms of specialization—it allows resources to flow to their most productive use, increasing how much can be produced (and consumed) in all trading partners. Restricting trade blocks these efficiencies from being realized, and leaves people worse off in aggregate—consumers unable to access goods and services they desire, and producers unable to source from the suppliers they view as most efficient to meet their customers' needs. Erecting barriers to trade is akin to compelling people who'd prefer to buy from Amazon to shop at a brick-and-mortar establishment, forcing producers to obtain inputs locally, rather than from a foreign source they find more efficient. Historically, it would have been like forestalling the switch from candles to electricity. It is a form of central planning, apt to result in less efficient resource allocation than private individuals selecting for themselves among the widest possible array of choices.

But what about trade deficits?

Aren't trade deficits an indication that a country is "losing" from trade, perhaps even being exploited by other countries? Umm…no. First, it's hard even to get an accurate read on bilateral trade balances in a world of integrated global supply chains. Much of what China produces for export to the U.S., for example, is just the finishing touches on products designed and early-stage produced elsewhere. Counting the entire sales price of the final product vastly overstates China's true value-add and the economically relevant size of China's exports to the U.S. But even when properly measured, bilateral trade balances are meaningless. Almost everyone runs a large trade deficit with their corner grocery store—buying lots from them without selling anything in return—and a whopping surplus with their employer—to whom they sell their labor services and typically purchase nothing in exchange. Yet few bemoan these bilateral trade imbalances.

True, aggregate trade deficits—summed across all trading partners—are different. They may matter. Like a household that spends more in total than it earns, a country that runs an aggregate deficit in trade—or more precisely, a deficit on its current account, which is the sum of its trade balance and its balance in international income flows—is spending more than it produces, borrowing from abroad to finance the extra investment that its domestic saving doesn't cover. But that's not necessarily "bad." It depends on what the borrowing is for. A household that takes on debt to finance the acquisition of skills, education, or a business that will boost its future earnings may be making a prudent decision. One that borrows to finance a drunken bout of gambling in Las Vegas, less so. It's a similar calculus for a country. A current account deficit is indeed worrisome if the borrowings from abroad are used solely to finance current consumption, making it harder to repay those external obligations, but is welcome if the capital is drawn in by bright investment prospects at home, and if it finances projects that ultimately validate those expectations.

A current account deficit is also not a sign that a country is "uncompetitive." Trade is driven by comparative, not absolute advantage. A country could be more efficient at producing everything than its trading partners, yet still benefit from importing items where its advantage is relatively smaller, and if it saved less than it invested at home it would run a current account deficit—competitive prowess notwithstanding. On the flip side, a country could be less efficient at producing everything than its trading partners and still be able to export items where its inefficiency was relatively modest, and if it saved more than it invested domestically it would log a current account surplus—hardly an indication of competitive strength. Similarly, a recession is often the surest way of bringing down a trade deficit, as investment collapses and spending restraint impinges on imports, but few would welcome such developments.

What matters is not the current account position per se, but what is driving the underlying saving/investment balance. For example, if the recent U.S. tax reform lures more capital into the country in anticipation of better after-tax returns and economic growth, and those capital inflows help turn these elevated expectations into reality, the increase in the current account deficit that must necessarily accompany them would not be a bane but a boon. By contrast, if a current account deficit is a result of excess spending or misallocated investment, it is a problem, but one that needs to be remedied at home—not something that can be fixed by imposing tariffs or other trade barriers. Viewing a trade balance as a scorecard of how well a country is doing, whether it is "winning" or "losing," is overly simplistic. Exports aren't inherently "good" nor imports "bad," trade deficits not a definitive sign of weakness or foreign malfeasance.

National security

Protecting domestic industries deemed vital to the nation's security is an argument often mustered to defend trade barriers. And there may sometimes be merit to these claims. But too often they are an excuse for protectionism—a cover used by domestic industries seeking special treatment. The recent U.S. tariffs on steel and aluminum are a case in point. Though defended on national security grounds, most steel and aluminum imported into the U.S. comes from friends and allies—many of whom have now been exempted from the tariffs, reducing the protection afforded to these domestic industries that were purportedly so essential to national security.

What if other countries aren't pursuing free trade?

This is an old standard trotted out by those seeking to mask their protectionist instincts in "fairness." They're all for free trade, if only other countries would play by the rules. And they sometimes have a point. China does likely flout global standards in its handling of intellectual property and technology transfer, and needs to be brought to account for its actions. But taking the case to the WTO and negotiating directly with China, in tandem with other countries that have similar beefs, is preferable to going rogue by imposing unilateral tariffs and other restrictions that could spark a damaging trade war. And in many other cases, the "fair trade" arguments are less compelling. Yes, some countries do not open their markets as widely as they could, or subsidize certain domestic industries. Here too, everything should be done to encourage countries to abandon these practices, either compelling them via the WTO or persuading them via negotiation that they are not only violating global norms but hurting themselves by promoting the interests of a few industries above their own aggregate welfare. Even if all that fails, however, a country would still be better off not erecting trade barriers of its own in retaliation. Better to accept the subsidy to its consumers and its producers who use foreign items as inputs, and realize that some domestic industries will be hurt, than damage the economy as a whole. Of course, those few on the losing end will have a different view. And that really goes to the heart of the debate about trade.

Distributional effects

Trade—even perfectly free trade—has adverse effects on some. Domestic industries that lose out to a fresh batch of foreign competition are a prime example. But the same can be said about shifts in tastes, technologies, and virtually all other economic change. They inevitably bring disruption and dislocation. The village blacksmith who lost out due to the advent of motor vehicles, Blockbuster driven out by Netflix, taxis hurt by ride-hailing apps—this is the "creative destruction" that is the beating heart of capitalism, the source of its vibrancy and ability to lift aggregate living standards. The sharp edge of international competition is just another example. Better to let these processes play out and help smooth the adjustment for those adversely affected than to thwart the engines of innovation. Or to turn protectionist.

Trade policy today: headed off the rails?

Yet that's just what some are threatening to do. The U.S. has pulled out of the TPP, browbeaten some domestic companies contemplating moving production offshore, threatened to ditch NAFTA, slapped tariffs on washing machines, solar panels, steel and aluminum, and now announced measures aimed at China—a 25% tariff on $50-$60 billion of Chinese imports, together with restrictions on China's investments in the U.S. Though these measures will cause some disruption and damage to economic efficiency, the impact on a macro level should be relatively modest. The China tariffs, after all, directly impact less than 0.3% of U.S. gross domestic product (GDP), and only a bit more if China retaliates moderately, as is likely, though the macroeconomic effect would grow if the trade frictions spark a sustained selloff in risk assets and tightening of financial conditions.

But the biggest concern is that these measures may be the opening salvo in an escalating trade war—one that undermines the rules-based global trading system and materially damages economic efficiency and growth potential, in the U.S. and globally. Although previous U.S. administrations imposed tariffs and other trade restrictions from time to time without sparking trade wars, none had the protectionist worldview that seems to dominate the Trump team—a mindset that sees trade as a zero-sum game, trade deficits as a domestic loss and a sign of foreign exploitation. This perspective is deeply misguided and worrisome, not least because it suggests the Administration's recent actions aren't isolated events but part of a broader agenda—one that resonates with a populist political base and, ironically, with a good chunk of left-leaning Democrats too, though not with the traditional Republican establishment. On trade, the normal left-right political divide has been upended. The China measures were also uncharacteristic in that they were not initiated at the request of a particular U.S. company or industry, but by the Administration itself, underscoring that this is a top policy priority.

Admittedly, China likely does violate global norms on things like intellectual property and technology transfer. But a better way of addressing the problem is through the dispute-resolution mechanisms of the WTO and determined negotiation. Ironically, despite all the U.S. bluster, that's where all of this may ultimately be headed. The U.S. may simply be using the threat of trade restrictions as a bargaining chip in negotiations. That's what seems to be happening with NAFTA, and there have been indications that the U.S. is willing to hammer out compromises with China too—and that China is open to negotiation as well. In the end, that's what we think will happen. That compromises will be reached, and a ruinous trade war will be averted. It's even possible that improvements to existing trading practices will be made. Still, some damage will be done in the interim, and risks of worse outcomes remain palpable. We haven't heard the last rumblings on the trade front.

Definitions

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The **North American Free Trade Agreement** is a treaty between Canada, Mexico and the United States.

The **World Trade Organization (WTO)** is the only global international organization dealing with the rules of trade between nations.

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