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Free trade under attack

Common misconceptions and lessons for investors

In a nutshell

- We consider three common misconceptions and draw four lessons investors should keep in mind when assessing the impact of recent trade tensions.
- International trade is not a zero-sum game. As a general rule, it benefits all the countries involved.
- Free trade is under attack. In direct and indirect ways, the results of this battle are likely to impact your portfolio returns for years to come.

A golden age that never was

A while ago, the well-known trade economist and 2008 Noble laureate Paul Krugman went on the attack. In a series of essays, he took aim at the new administration's trade priorities. He was especially harsh on several key advisors on international trade of the recently elected U.S. President. Krugman described them as "people who speak impressively about international trade, while ignoring basic economics and misusing economic figures." He conceded that "despite the ignorance about international economics, (…) the actual performance of the Administration has been quite gratifying to a free trader." Nevertheless, he lamented: "Over the past decade or so, a deeply misconceived ideology of international trade has taken hold of much of the public discussion in general." The president in question was Bill Clinton. Krugman's essays eventually became quite an entertaining and still very informative book, first published in 1996.[1]

If you have never thought hard about international economics, and have a bit of time to figure out how the world's trading system got where it is today, I would strongly encourage you to track down a copy of "Pop Internationalism." Those essays remain an excellent place to start understanding trade – and how the thinking among economists has evolved. They certainly helped inform my own take on what to make of the more recent trade tensions.

To start with the obvious, policymakers' and the media's misunderstanding of basic economic concepts is nothing new. Nor is the resulting grumbling among practitioners of the dismal science. In the real world, trade deals almost always fall short of what economists would desire. In part, this is because trade liberalization, like tariffs, is usually the product of political processes.

In retrospect, the 1990s might look like a golden age for free trade and globalization. Even at the time, however, support among policy makers and the public at large was relatively weak and ill-informed. With the benefit of hindsight, it turns out that several of the key assumptions among economists were equally misguided. In the next three sections, I will explain how and why the following three ideas underpinning the golden-age consensus have proven wrong and what lessons to draw. The first one was widely held among policymakers. The other two are a bit of a mea-culpa on behalf of older economists like myself.

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[1] Krugman (1997). The passages cited are on p. 82, 113, and on the cover.

1. "Countries, just like companies, are engaged in a global contest; some countries gain while others lose."

In the 1990s, policymakers became increasingly concerned with international competitiveness. Many, starting with President Clinton in the U.S. and Jacques Delors in Europe, felt that countries, just like companies, are engaged in some sort of global contest. In an increasingly competitive global environment, countries, just like companies, need to innovate. To succeed, they need to get their own policies in order. There was simply no alternative.

2. "In the United States, trade is a bit of a sideshow. The real story has been about technology."

Both trade and technology can destroy jobs in the short term. Provided that labor markets are sufficiently flexible, however, there should be little impact on employment in the longer term. And while both trade and technology can impact wage inequality, trade has historically tended to play only a limited role. Unlike the first misconception, this was broadly true in the second half of the 20th century. For example, from around 1970 onwards, wages for low-skilled workers in the United States began to lag behind those of more highly skilled workers. Trade appears to have had fairly little to do with this. As we will see, however, that changed around 1990, if you look at local labor markets rather than the U.S. economy as a whole. Since then, local labor-market adjustment turned out to be far from smooth. Trade with China appears to have contributed to big divergences in regional economic performance. The electoral consequences of this appear to have been equally outsized.

3. "While trade produces winners and losers within countries, political processes in democratic societies can and will ensure that gains are distributed fairly before too long."

This final misconception arguably proved to be the most consequential one. Indeed, one way to think about recent electoral events and trade tensions is as a revolt of the losers from globalization against the winners. Think of them as a belated sign of political processes finally working – if not quite in the ways you might have wished or expected.

In the **remainder of this note**, I will mainly look at each of those ideas in more detail. The goal is to re-examine some widely held assumptions among my generation of economists when thinking about ongoing trade discussions. Each concludes with some lessons I would draw in light of the evidence of the past 20 years.

The **final chapter** of this note will outline **our take on ongoing trade talks**. If you wish to, you can also jump straight to it, as it can be read independently of the preceding sections. This too contains a valuable lesson investors and market commentators should keep in mind.

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Misconception no. 1

"Zero-sum game"

"Countries, just like companies, are engaged in a global contest; some countries gain, while others lose."

As a general notion, viewing trade as a zero-sum game is deeply misguided. Trade between two people is as close as you can get to a free lunch. If you got an apple and prefer oranges, while I got an orange and prefer apples, we can both gain from trading with each other. The same logic holds for only slightly more complicated economic relationships, such as those found in the labor market. If you are quite good at both typing and writing sophisticated policy papers – better than me, in fact –, it might still make sense for you to hire me as your typist. Doing so gives you the time to focus on the things you are best at. And over time, I will probably get better at typing.

The same logic broadly holds for countries. A good way to think about international trade is to see it as analogous to a production process. Like a production process trade transforms inputs (your country's exports) into outputs (the imports you are able to buy from your export proceeds). Generally, both countries involved will only participate in such an exchange if they both gain from the trade. To make this point, Krugman recites a parable from an earlier textbook by James Ingram. He writes about an entrepreneur who "starts a new business that uses a secret technology to convert U.S. wheat, lumber and so on into cheap high-quality consumer goods. The entrepreneur is hailed as an industrial hero; although some of his domestic competitors are hurt, everyone accepts that occasional dislocations are the price of a free-market economy. But then, an investigative reporter discovers that what he is really doing is shipping the wheat and the lumber to Asia and using the proceeds to buy manufactured goods – whereupon he is denounced as a fraud who is destroying American jobs." [2]

If anything, however, this story is likely to understate the actual gains from free trade. If the U.S. is already quite good at growing soy beans and not quite as good in producing cheap consumer goods, it might get even better over time, by specializing in soy beans and, perhaps, in designing rather than producing high-quality consumer goods. As a result, support for free trade is one of the few policy areas almost all economists can actually agree on.

The case for free trade ...

Back in March, my colleague Josh Feinman took a closer look at growing trade tensions (see "A Closer Look"). If you did not read it at the time, I strongly encourage you to do so now. Along the way, our U.S. Chief Economist offers a spirited defense of the benefits of free trade and dispels several myths. This includes common misperceptions about bilateral trade balances.

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[2] Krugman (1997), pp. 119

"Aren't trade deficits an indication that a country is "losing" from trade, perhaps even being exploited by other countries? Umm… no." Josh writes, before explaining, "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."

What I found most striking, however, was the start of the piece. "It should not be necessary" Josh writes, "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."

I will get back to why I found this so striking. For now, I would like to stress that in terms of the facts, Josh is absolutely right. There is, indeed, a lot of evidence on the benefits of international trade. As with a new production process, some workers and sectors might lose out. In the example above, an imaginary "secret technology" that allows the U.S. to convert wheat, lumber and soy beans into cheap high-quality consumer goods, such as toys or washing machines, will make U.S. farmers and farm workers better off. At the same time, those owning now uncompetitive factories making toys or washing machines will be worse off, and so will their workers. For the U.S. as a whole, though, trade is generally a good thing - in the same way, and for the same reasons that new technologies are. It benefits consumers.

... is really the case for free markets

Trade allows countries to specialize in the areas they are best at. This generally tends to leave all countries involved better off, both when they start trading and as they continue to get better in producing goods and services they are already quite good at. If you work with an initially slow typist, he or she will eventually get faster. Such economies of learning are one of the reasons why the benefits from trade and specialization tend to grow over time. Within a generation, the results between an open, free-market capitalist economy and a closed, state-run one can be dramatic. Just think back to East and West Germany – or indeed to today's contrasting fortunes on the Korean peninsula.

Are there exceptions to this rule? Yes, but if you look at both economic theory and economic history, these exceptions tend to be of limited practical significance. For example, you might

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occasionally identify national industries that were initially sheltered by tariffs or other forms of government support and eventually grew into world-beaters. Early U.S. trade policy and Germany's 19th century customs union are frequently cited – if slightly dubious – examples of how such infant industry protection can work.

Depending on the industry, such government interventions might even be worthwhile for the country in question. The aerospace sector is a frequently mentioned example. Given the huge amounts of capital investment and risky research and development involved, there appears to be scope for only a very small number of players worldwide. So, it is fairly easy to see how government intervention at the right moment could have helped particular countries or regions emerge as one of two or three global producers.

The closer you look at real-world cases, however, the less clear-cut the evidence usually is that this sort of intervention produces gains in excess of the costs involved. Why? Because generally, governments and state bureaucracies have not been very good at picking winners. At a very basic level, the case for unilateral trade liberalization is the same case you can make for free markets and against state planning in general. After all, there is always an alternative to free markets and free trade. It's called government intervention.

Of course, pointing this out does not conclusively settle the debate. Are industrial policies always as flawed and government bureaucracies generally as incapable at picking winners as I still tend to think? Or might the Trump administration and its Chinese counterparts be onto something in getting into such a tiff over China's willingness to splash out hundreds of billions on favored currently fashionable sectors like artificial intelligence, semiconductors, electric cars and commercial aircraft? So far, the evidence suggests that even the Chinese are not all that good at picking winners - except, perhaps, in very specific sectors such as green energies where other sources of market failure strengthen the case for government intervention. [3]

If you re-read this paper in twenty years, however, it is quite possible that some government, somewhere, will finally have come up with a way to pick winners better than the private sector and make industrial policy work consistently. Or at least there is no theoretical reason to consider it impossible for some set of government bureaucrats, somewhere, to consistently be beating private-sector venture capitalists. All we can say for now is that it would be a touch surprising.

Lesson 1

There is only so much in economics you can know for certain. But when you do, try to educate others.

Which brings me to my first lesson from reconsidering trade. Some misconceptions are clearly and demonstrably wrong, and always will be. Viewing trade in your typical garden-variety goods

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[3] For two recent examples on opposite ends of this – probably never ending – debate, see Rodrik, D. (2013) and Howell, A., (2016)

or services (apples and oranges, say) as a zero-sum game falls squarely into this category. The more you can free up trade around the world, the better all countries will be able to specialize in what they are good at. By contrast, there are many, many other economic insights you might have been taught, that "only" make sense in light of the evidence so far. Whether they will still make sense in the future, however, will and should depend on what the evidence shows from now on.

Understanding this distinction is key when interacting with non-economists, because it is likely to equip you with the right combination of humility and intellectual backbone. An anecdote Paul Samuelson, another economics laureate, liked to recount makes this point quite nicely:

"[O]ur subject puts its best foot forward when it speaks out on international trade. This was brought home to me years ago when I was at the Society of Fellows at Harvard along with the mathematician Stanley Ulam. Ulam, who was to become the originator of the Monte Carlo method and a co-discoverer of the hydrogen bomb, was already at a tender age a world-famous topologist. And he was a delightful conversationalist, wandering lazily over all domains of knowledge. He used to tease me by saying, 'Name me one proposition in the social sciences which is both true and non-trivial.' This was a test that I always failed. But now, some thirty years later, on the staircase so to speak, an appropriate answer occurs to me: The Ricardian theory of comparative advantage; the demonstration that trade is mutually profitable even when one country is absolutely more - or less - productive in terms of every commodity. That it is logically true need not be argued before a mathematician; that it is not trivial is attested by the thousands of important and intelligent men who have never been able to grasp the doctrine for themselves or to believe it after it was explained to them." [4]

The fact that many "thousands of important and intelligent men" and women don't get it is quite interesting in itself. It presumably tells us something about how the human mind works. Indeed, if I had to venture a guess, I suspect that the list of policymakers who never understood the notion of comparative advantage is quite long. The difference is that some institutions tend to do a better job in ferretting out policy errors and getting closer to what the correct answer may be.

In praise of the World Trade Organization

Broadly, that has been the case in many of the liberal democracies in the Western world. One particularly important innovation has been the creation of a multi-lateral, rules-based framework underpinning international trade. This idea, promoted by the United States as a policy priority after the Second World War, has probably done more than anything else to promote prosperity around the world. Now under the umbrella of the World Trade Organization (WTO), these rules might seem to limit what any one nation can do.

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[4]Samuelson, P. (1969) p. 9

But as my younger colleagues might put it, this is actually a feature, not a bug. The WTO has made trade-dispute resolution more predictable, benefitting consumers, workers, companies and financial markets. And, like the rule of law more generally, international trade law can help limit corrupt practices. When two countries negotiate bilaterally, an industry or special-interest group only needs to influence one, at most two governments, to win special favors – temporary relief under the guise of a quota, say. This is much harder when disputes have to be settled by an independent WTO tribunal, charged with consistently applying an agreed set of rules to each specific case.

A multi-lateral, rules-based framework can also limit the damage political brinkmanship can do. If the UK, say, falls out of the European Union without a new trade deal, it would at least have WTO rules to fall back on. Moreover, the rules-based, multi-lateral framework of the WTO does something pretty marvelous. When discussing trade with their counterparts from around the world, it makes policymakers behave as if they had bought into the notion of Ricardian theory of comparative advantage, whatever their personal views on free trade. If a key industry enlists your help in opening up foreign markets and you happen to think of trade as a zero-sum game, you are likely to demand "concessions" in return. Your foreign negotiating partners will take the same approach. And, after a lot of haggling, your deal will reflect a give-and-take that moves all parties closer to free trade. Each tariff or quota you "concede" might well make economic sense unilaterally but would be politically impossible without some "concessions" you win in return. [5]

Because of political constraints, the case for free trade is often made on slightly dubious pretenses. Much of the time this is fairly harmless. In less direct ways, however, it can do lasting damage.

Misconception no. 2

"Little long-term impact"

"In the United States, trade is a bit of a sideshow. The real story has been about technology."

We have already seen that in terms of the economic effects, trade and technology are quite similar. Perhaps as a result, economists have been fairly slow in adjusting their thinking about trade. In retrospect, it is becoming increasingly clear that something big changed in the 1990s. This particular something was China's entry into the global trading system, after more than 70 years of relative isolation. In recent years, a series of research papers has suggested that the impact of the "China shock" has been far more wide-reaching than once thought plausible.

In a 2013 paper, David Autor, David Dorn and Gordon Hanson showed that between 1990 and 2007, growing Chinese import competition played a decisive role in reshaping local U.S. labor markets. Their starting point was that within the U.S., there is

[5] A similar logic holds for bilateral trade talks. However, there is a risk. Bilateral deals generally introduce new barriers to countries not involved in the talks. This tends to divert trade flows. Economic theory cannot tell us whether the benefits will outweigh the costs to the countries involved (as a practical matter, they often do).

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plenty of variation in terms of industry specialization. Using quite an innovative approach, they were able to identify geographic areas particularly exposed to the "China shock". Commuting zones that had, say, large employers specialized in making toys or washing machines.

Once Chinese competition began to heat up, employment in these highly exposed sectors and areas rapidly shrank. In total, Autor and his colleagues estimate that the "China shock" appears to explain about one-quarter of the fall in U.S. manufacturing employment – with corresponding increases in unemployment, disability, retirement and healthcare benefits. A series of related papers explored the impact on voting behavior in the 2016 U.S. presidential election, political polarization and even the marriage prospects of young men within affected communities.

Before Trump, there was Brexit

In the aftermath of the initial paper by Autor and his colleagues, a cottage industry has emerged on both sides of the Atlantic refining and extending their approach. Needless to say that for such a relatively new research agenda, it will take a while until a clear picture of (recent) economic history emerges.[6] And, while globalization in general (and China in particular) appears to have had large distributional effects within local labor markets, a recent meta review of the research literature by Helpman, E. (2017) found that its impact on overall wage inequality has been modest. Despite the China effect, globalization can explain only a fraction of the increase in wage inequality within both rich and poor countries. That rise in inequality appears largely due to other factors, including technological change, change in labor-market structures, and forces yet not well understood.

But even if it is most discernible at the local, rather than the national level, the "China shock" appears to have had big electoral consequences. On this, the evidence so far is highly suggestive. Using the same basic approach as Autor, a recent paper by two Italian economists, Italo Colantone and Piero Stanig (2016), suggests that surging Chinese imports, of all things, were instrumental in the Brexit referendum of 2016. In terms of which English and Welsh regions voted to leave the European Union, and by how much, it appears that exposure to Chinese import competition had much more predictive value than, say, recent migration patterns. Specific grievances about, for example, increasingly scarce and underfunded public services no doubt played a role. However, the results reported by Colantone and Stanig suggest that localized economic decline triggered by the "China shock" may have been the main driver.

On this view, anti-immigration sentiment and the broader backlash against Brussels and the establishment in general were mere symptoms. This may help explain a well-known Brexit paradox, namely that hostile attitudes towards migration appear to show little or negative correlation to whether there actually are migrants.

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[6] In particular, the role of China in creating (export) jobs may need to be explored further. See, for example, Feenstra, R.; Ma, H.; Sasahara, A , and Xu; Y. (2018).

Broadly speaking, regions that had seen a large influx of EU citizens such as London tended to vote in favor of remaining within the Union. (EU citizens were not allowed to vote in the referendum.)[7]

Taking a long view

Of course, there are limits to how much any one development, even one as significant as the rise of China, can explain. No doubt, other issues played a role. Some of them might also, more tangentially, be related to trade. For example, some economists have long been fretting that the high mobility of capital and highly skilled workers makes taxing the winners of globalization harder. As a result, funding for public services and redistributive policies might become difficult to maintain. This might, over time, increase inequality and erode support for free trade. [8]

A more complete account would need to pay attention to other changes too. In particular, there is growing evidence of monopsony effects in U.S. labor markets. [9] This means that each employer has a certain amount of market power – its hiring decision has a measurable impact on market wages for the kind of workers it is looking for within any given local labor market. Such employers benefit from similar effects to those captured by a monopolist in product markets. On this view, a shrinking number of employers within some of Autor's commuting zones might have contributed to the malaise.[10]

All this is quite significant in assessing the correct policy responses. And none of it means that imposing tariffs on Chinese imports now could reverse the decline. Nor is it all that unusual for economics to take a while in figuring out what actually happened. Plenty of big things happen all the time. Often, it takes a while until you see it in the data. And even to this day economic historians can still debate what exactly contributed how much to the Great Depression of the 1930s. Which takes me to my second lesson.

Lesson 2

As it unfolds, economic history is rarely as clear cut as it might one day appear in your economic textbook. And the empirical regularities that have served well in recent decades might not hold in the future.

One obvious implication of this is that just because China has had a bigger impact on wage inequality, local employment levels and voting patterns than initially thought does not mean it will continue to do so. In compensating for past errors of judgment, it is tempting, but probably misguided, to now err in the opposite direction.

There is a better approach. When, to paraphrase Samuelson, hundreds of important and intelligent economists get something

[7]For similar reasons and somewhat less convincingly, a related paper by Colantone, I. and Stanig, P (2017) suggests Chinese imports may have played a significant role in the rise of right-wing nationalism in Western Europe more broadly.

[8]See, e.g., Rodrik, D. (1998) and Rodrik, D. (1997)

[9]See Naidu, S., Posner, E and Weyl, G., (February 23, 2018) for an overview of the recent evidence and potential policy responses.

[10]For illustration imagine a relatively rural commuting zone somewhere in the Mid-West. 30 years ago, major employers in the area included a toymaker, the only major industrial employer. Others included half a dozen hospitals. Since then the toymaker shut down due to rising Chinese imports, while all hospitals are now part of the same hospital trust. As a result, the trust has been increasingly able to hold down wages of doctors and nurses in the area. In this example, it would be had to tell from the data how much of the relative wage decline is trade related. The same would be true of the resulting political fall-out.

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wrong, a good way to learn from their mistakes is to think how they could have done better. In the case of trade versus technology, you certainly cannot fault the likes of Paul Krugman for their views back in the 1990s. The data was reasonably clear-cut and for good reasons. Until the "China shock" came along, most international trade took place in broadly similar goods, and between countries of broadly similar levels of economic developments. Since the 1970s, trends such as the fall in manufacturing employment, growth in services and a growing wage premium of better educated workers were making themselves felt in many industrialized countries, more or less simultaneously.

As a result, it looked a lot more plausible to suspect similar changes in production technology across a wide range of similar countries, rather than growth in international trade, could explain these trends. Nor can you fault Mr. Krugman for failing to take the new evidence into account as it became available. Indeed, much of his early theoretical work dealt exactly with the sort of localized effects that Autor and his colleagues eventually uncovered in the data.

In my view, however, there are two related biases many economists were and remain guilty of. One is our failure to acknowledge how large the gap is between what we can demonstrate using basic micro-economics and how an economy functions as a whole. You need to look at the details to figure out what might really be going on, as the papers by Autor and his colleagues neatly illustrate. I suspect it is quite broadly applicable. Take the flattening Phillips curve. Presumably, many different forces help explain why the links between wages, unemployment and consumer prices appear to have gotten weaker in recent decades. But to figure out what these forces are and how they interact, you need to move beyond simple narratives at the level of the economy as a whole. In the case of the Phillips curve, we previously described why we think that "the familiar story about demographics, technological change and globalization is incomplete and inconsistent with much of the data." (see "Low and slow for now") The same is true, I suspect, of many of the implicit assumptions on how "the" economy works. In the technical jargon, much of contemporary macro-economic thinking still does not have proper micro foundations. Until this is addressed, we should beware of a second, related bias. Economists tend to dismiss voters or policymakers as ignorant, when a proposed policy is at odds with contemporary orthodoxy. Instead, it might be better to see such challenges as signals of changes afoot in the real world that might only appear in the data a few years later. Which takes me to the third misconception outlined at the start of this paper.

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Misconception no. 3

"Gains are distributed fairly"

"While trade produces winners and losers, political processes in democratic societies can and will ensure that gains are distributed fairly before too long."

This plainly didn't happen in the case of the "China shock." Trump and Brexit did not come out of nowhere. As we noted almost two years ago, in a Special introducing our U.S. election watch, trade was the key factor underpinning Donald Trump's success in the Republican primary. "Opposing free trade gave him a unique selling proposition. That put other candidates in a difficult spot when trying to make a credible counteroffer to voters without losing business support," we wrote (see "Introducing our U.S. election watch 2016"). In our key takeaways, we pointed out that his mere candidacy had already "significantly eroded Republican support for free trade, once a core article of faith among Republican policymakers."

We argued that "investors should be cautious in applying old rules of thumb. For the past 36 years, Republicans have reliably tended to pursue market-friendly supply policies, while showing themselves pragmatic on countercyclical spending in times of economic duress. It is less clear that this will continue to be the case. A Trump victory might, for example, increase existing congressional pressures to tighten the Fed's scope for maneuver. Across the board, policymaking would probably become harder to predict."

What even we may have underestimated, however, is how much of the political turmoil in U.S. policymaking reflects not just the candidate's idiosyncratic personality and policy mix. Instead, it probably reflects deeper, structural factors outlined above, playing out in local labor markets, in the two decades leading up to Donald Trump's election – and the UK vote in favor of leaving the European Union. Which takes me to my third lesson.

Lesson 3

When a number of once unthinkable things happen in rapid succession, start thinking the unthinkable going forward.

On trade, many of today's investors simply take it for granted that eventually we will see economic rationality reassert itself. I am a touch more skeptical. This may partly reflect personal experiences of the sort that continue to shape one's perceptions throughout one's adult life. I grew up within several hours driving distance of what was then the Iron Curtain.[11] Perhaps as a result, I have less confidence than my British or American colleagues in bad economic policies fading, simply because a growing amount of evidence suggests that they are harmful.

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[11] The Iron Curtain refers to the extensive border defenses between Eastern and Western Europe during the Cold War.

Mainly, however, it is because misguided economic ideas tend to leave a lasting legacy, even if their immediate, practical fall-out at first appears benign and limited. That dangerous 1990s obsession with international competitiveness is a good example. Initially, it probably helped in winning support for trade-liberalizing measures. Eventually, however, the kind of thinking Krugman attacked in the 1990s – that trade is a global competition with winners and losers – paved the way for politicians keen to put Italy or France or Britain or China or America first. By undermining the WTO, I fear that recent U.S. trade measures could have a similarly indirect, but ultimately much worse detrimental effect on economic policymaking in the longer term.

The main countries currently standing up for the multi-lateral, rules-based approach the U.S. has long helped to foster are France, Germany, Japan and China. This might strike some as a touch surprising. France invented both mercantilism and the notion of national champions. Germany has a long history of infant industry protections and promoting the idea, now incorporated in much of the policymaking throughout the Eurozone, that current-account surpluses are inherently virtuous. Japan has long been the poster child for industrial policies in order to make favored industries internationally competitive. China is frequently, and with some justification, accused of being a serial violator of international rules, notably on intellectual-property protections. These are now the unlikely "champions of free trade." With this in mind, let's turn to current policy debates surrounding trade.

What to expect from ongoing trade talks

Trade tensions have been rising

In recent months, trade tensions have been rising and not just between the U.S. and China. Global trade, however, has been doing just fine, as one of our recent Charts of the Week showed. International trade in goods and services tends to be pro-cyclical. It rises disproportionately in good times, while contracting sharply during recessions. As a result, it appears to have gotten a boost from ever larger chunks of the global economy all growing simultaneously.

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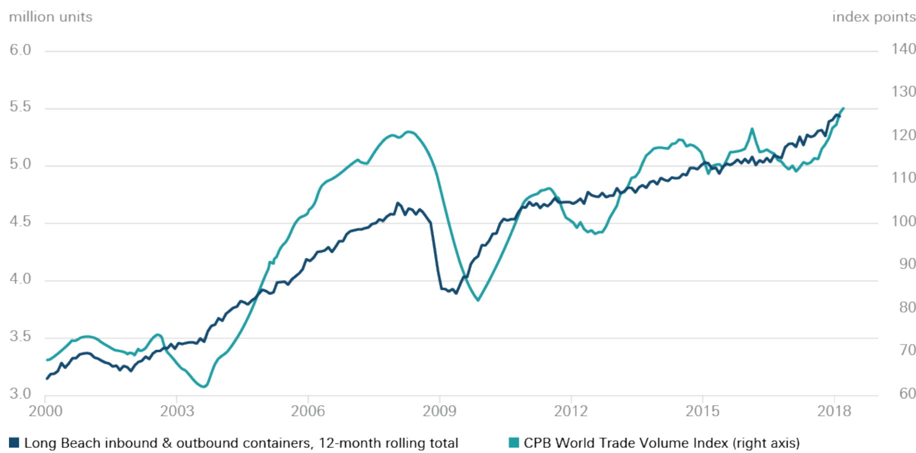
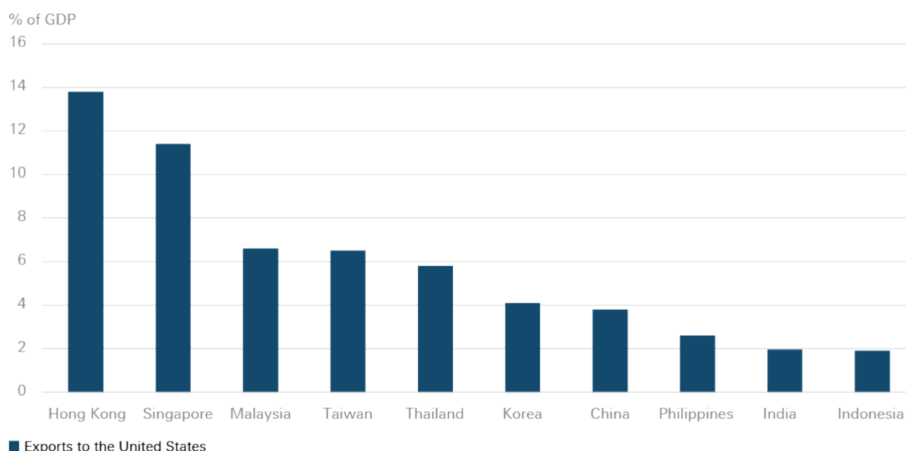
Global trade remains in excellent shape



Sources: Bloomberg Finance L.P., Deutsche Asset Management Investment GmbH as of 4/18/18

Can it last? Or are we just a few tweets away from a trade war that might derail the global recovery? Once you crunch the numbers, it becomes pretty clear that the short- to medium-term risks should be manageable. My colleague Elke Speidel-Walz, Chief Economist for emerging markets, has done just that. As an extreme scenario, imagine a 20% increase in U.S. tariffs on all Asian emerging markets, followed by those markets hitting back with similar measures. That could reduce U.S. growth by 1% in the first year and another 0.5% after five years. Smaller, more open Asian economies, such as Hong Kong, Singapore and Taiwan could be hit harder, given the size of both their direct exports to the U.S. and their role as providers of intermediate materials assembled in China. For China itself, the impact is likely to be surprisingly modest, given the low and shrinking contribution of net trade to Chinese gross-domestic-product (GDP) growth.

Exports to the U.S. as a share of GDP



Sources: Morgan Stanley, Deutsche Asset Management Investment GmbH as of 1/24/18

Of course, any sustained impact presupposes that trade restrictions will be imposed and remain in place rather than merely announced or threatened. In our view, this remains unlikely. New tariffs of $12bn imposed by the U.S. in January on solar cells and modules as well as on washing machines have not been followed by other measures on specific consumer products. The announcement of steel and aluminum tariffs in March was watered down in

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subsequent weeks, with the European Union, Canada and Australia being granted an exemption until May 1st, which has since been renewed by another month. South Korea has been exempted permanently, as part of a revamped trade agreement with the U.S.

The South Korean case

The trade deal between South Korea and the U.S. is instructive. It came within days of U.S. President Donald Trump announcing the new tariffs on steel and aluminum via Twitter. South Korea agreed to lower some administrative barriers to the sale of U.S. cars in the country, streamlining customs procedures and tweaking the rules on how much South Korea's National Health Insurance Service pays for new U.S. made drugs. By far the most widely touted "concession" was that South Korea will accept a quota limiting steel exports to the U.S. to 70% of the annual average of recent years. Apparently, the Trump administration saw this as a "satisfactory alternative" to address their concerns. [12]

In economic terms, a quota has exactly the same effects as a tariff on U.S. customers. Both lead to higher input costs when U.S. companies buy South Korean steel. The difference is that by using quotas, the U.S. government will not get to collect tariff revenues. Instead, those Korean producers lucky enough to secure export quotas will pocket the difference, at the expense of U.S. buyers (and, ultimately, U.S. consumers). As with most restrictions on free trade, both the Korean and the U.S. economy are likely to lose – but Korea will lose a little less and the U.S. a little more than they would under a tariff. It seems quite plausible that if U.S. steel imports are restricted by either quotas or tariffs, U.S. job losses at companies buying steel will actually exceed the number of jobs "saved" or created within the U.S. steel industry.

Most market observers think that this sort of a deal will serve as a template for the Trump administration's ongoing discussions with China and the European Union, as well as Canada and Mexico on the North American Free Trade Agreement (NAFTA). In all these instances, the U.S. might secure crowd-pleasing "concessions" for the benefit of politically well-connected industries, mainly at the expense of U.S. consumers.

Consensus thinking

Implicit in this is the idea – amply demonstrated by the discussions so far – that the U.S. administration has little grasp of and limited interest in the economics of international trade. (This starts with such trade accounting basics as the fact that a country's aggregate current-account position is just the mirror image of its capital account – how much companies, households and the government save and invest.) On this somewhat cynical view, the path towards "compromises" should be fairly easy. All it requires is for knowledgeable Chinese, European, Mexican and Canadian trade negotiators to follow the Korea strategy – allowing the U.S. to secure the occasional "concession" mostly at the expense of U.S. importers, and, ultimately, U.S. consumers.

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[12] https://www.whitehouse.gov/briefings-statements/president-donald-j-trump-fulfilling-promise-u-s-korea-free-trade-agreement-national-security/

Optimists readily admit that, there may be risks along the way towards compromise. For example, U.S., Chinese and perhaps European brinkmanship could result in things getting out of hand, at least for a while. The U.S. might implement additional tariffs or other restrictions. Other countries might retaliate. Uncertainty might spread, hurting sentiment among companies and in financial markets. However, the immediate fall-out is likely to be fairly limited. A few misguided tariffs, quotas or other restrictions might do some, but not all that much damage in the grand scheme of things. And long before much damage is done, targeted measures of the sort China is already threatening will make voters in critical battleground states reconsider ahead of the U.S. midterm elections.

All of which sounds plausible enough, as far as developments during the next 6 to 12 months go. Needless to say, we are monitoring discussions closely, but for now, it seems more likely than not that the economic and financial fall-out from global trade tensions will be limited in both its scale and timing. I wonder, however, whether consensus observers are simultaneously underestimating the longer-term risks to the rules-based framework underpinning international trade.

Missing the wood for the trees

As argued in Sections 1 to 3 of this paper, one way to think about recent economic history starts with acknowledging some of the misconceptions that dominated thinking about trade back in the 1990s. The first is to see trade as a zero-sum game, in which countries compete. Partly as a result, the efficacy of industrial policies now appears to be taken for granted by both the U.S. and China. As outlined above, this appears highly dubious, and if you scratch the surface, it is really an attack on free markets more broadly. Second, economists have underestimated the role the "China shock" played in hurting local labor markets, particularly in areas that voted for both Trump and Brexit. Third, democratic processes did not lead to fair distribution of the gains from globalization. The resulting changes in how the electorate thinks about trade are unlikely to go away any time soon.

When a number of once unthinkable things happen in rapid succession, start thinking the unthinkable going forward. From an investment perspective, the risks go well beyond the odd tariff here or the quota assigned to a favored country or sector there.

As I begin to draw my final lesson of this paper, my starting point is an excellent and timely column by the economist and columnist Martin Wolf in the Financial Times. "Donald Trump declares trade war on China," Mr. Wolf writes and goes on to explain why "no sovereign power could accept the humiliating demands being made by the U.S."[13] Least of all China, I would add. To me, it seems that whoever wrote the set of U.S. policy demands was either deliberately trying to provoke China or – more likely – knows little about Chinese history, the Opium Wars[14] and the continued

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[13] Wolf, M. (2018)

[14] In the two Opium Wars (1839–1842 and 1856–1860), Europeans led by the British successfully fought China to open up to international trade, including in opium. These wars resulted in China's military defeat and diplomatic humiliation. Indeed, Chinese history books to this day tend to describe the opening shoots of the first Opium War as the start of a "Century of Humiliation", due to foreign powers continuously interfering in China's affairs.

outsized role this 19th century "trade" dispute plays in Chinese policymaking and the Chinese national psyche.

Lesson 4

Things that you don't know or think about can still hurt your portfolio

By singling out China and behaving like "a self-regarding bully", as Mr. Wolf puts it, the Trump Administration risks sending a broader message. Among its unreasonable demands, many explicitly insist on China refraining from challenging U.S. measures or retaliating to the extent allowed under WTO rules. China has even been asked to withdraw existing complaints at the WTO. "Rules only apply to others, but not to us," the Trump Administration appears to be deliberately signaling. To put it mildly, this seems unwise, especially as America would have probably had strong cases to make under WTO rules to address its main grievances. By damaging faith in the WTO, it risks doing lasting damage, well beyond the current trade talks with China.

Might people like Paul Krugman and Martin Wolf be wrong on this? Of course, myself very much included! Perhaps we are underestimating the cunning of U.S. negotiating tactics and the chances of these tactics resulting in a quick and mutually beneficial agreement. Only "Nixon," the old aphorism goes, "could go to China."[15] Perhaps something similar will soon be said about Donald Trump. Given the deep and structural forces that underpinned the rise of U.S. protectionist sentiment, he alone, perhaps, could actually deliver a free-trade deal of the sort acceptable to angry voters. Who knows, in retrospect, even Mr. Krugman might one day be ready to admit that "despite the ignorance about international economics, the actual performance of the Administration has been quite gratifying to a free trader," just as he did long ago about the Clinton Administration.

We would certainly welcome such benign results, but still caution investors about the long-term costs of some of the negotiating tactics the U.S. has recently used in order to get there. One especially glaring example concerns a Chinese maker of mobile phones. The Chinese company is the world's fourth largest telecoms-equipment firm. Among other infringements of U.S. domestic law, it was found guilty of illegally shipping U.S. goods and technology to Iran and North Korea. Earlier this year, it agreed to pay $900m in fines and penalties, plus $300m in suspended payments, in case it violated its obligations. In April, the U.S. Commerce Department followed up with further sanctions, banning U.S. companies from selling software and hardware to the Chinese culprit for seven years. As a justification, the U.S. claimed that the Chinese company had repeatedly made false statements.

Without going into the details of this case, let us assume, for the sake of argument, that the Chinese company was indeed guilty of all the alleged violations. You might still ask whether using export

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[15] This refers to the visit of U.S. President Richard Nixon to China in 1972. Nixon was a well-known opponent of Communism. As such, he was able to negotiate a new relationship, without inviting cries of betrayal of U.S. national interests. The visit resulted in the establishment of direct diplomatic relations with the People's Republic of China.

restrictions on U.S. high-tech components as a bargaining chip makes any sense.

On purely pragmatic grounds I fail to see how. By imposing the export ban in such a sudden and capricious way, the U.S. is signaling to buyers in China and elsewhere that their supplies might be at risk. It might as well be running a full-page ad in the world's business press saying "Don't buy Made in the USA," when it comes to critical (and often high-margin) components. Already, the ban appears to have crippled not just the Chinese company, but several of its U.S. suppliers, too. One of them, a Massachusetts-based maker of optical components, lost almost 40% of its market value. Like several other U.S. suppliers, it may struggle to survive the fall-out.

Effectively, the Administration is favoring steelmakers at the expense of companies producing optical components. At best, this seems like an odd way to pick "winners" and "losers." At worst, it carries whiffs of crony capitalism. Indeed, this is probably the term observers would use if we were talking about the leadership of any other country taking similar steps.

This is not how enforcing laws and due process are supposed to work, either under U.S. domestic law or under international trade law. Respect for the rule of law and private-property rights, even those of unsavory foreigners, let alone their U.S. trading partners, have long been an important factor underpinning U.S. soft power world-wide. They are also underappreciated reasons why U.S. companies are attractive to foreign investors.

If the Chinese company is guilty, it deserves to be punished to the full extent of the law, independently of any concessions China's government is willing to make in other areas. A 7-year ban on buying U.S. components appears somewhat disproportionate, but that question too should have nothing to do with high-level trade negotiations between the two governments. Mixing the two might prove beneficial in the short term, but at a significant cost later on.

This brings me back to the excellent piece by my colleague Josh Feinman, and that phrase I found especially striking. "It should not be necessary to defend the benefits of international trade." Nor should it be necessary, in 2018, to explain why liberal democracy, free markets and the rule of law are sound ideas, with more than two centuries of evidence to back up their comparative virtues. But just as Josh was implicitly taking the case for free trade as granted, we all do when it comes to the broader economic and political system we live in.

History suggests that this may be short-sighted. Public support for free trade, free markets and the rule of law is highly conditional. Partly, it appears to depend on these institutions delivering prosperity. Partly, it depends on sharing the fruits of prosperity fairly. And mostly, it depends on institutions and elites in democratic countries being able to defend or regain their legitimacy by eventually coming up with effective policy responses to new challenges. In countries where free markets, private-property rights

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and due process are relatively young, they also depend on the U.S. setting a good example.

The world has long relied on the U.S. to defend and uphold the rule of law, including binding international trade law under the WTO umbrella. Knowingly or not, the Trump Administration is putting this stunning achievement of American post-war diplomacy at risk. Faith in the WTO can only be strong, if even large and powerful countries act in good faith. And even if the WTO, its rules and its mechanisms to settle disputes survive – an increasingly big "if" – merely testing those limits is already setting scores of dangerous precedents other countries like China might try to exploit in the future.

Norms of behavior are a lot easier to destroy than to establish. This is especially so for relatively new norms, such as those underpinning the multilateral, rules-based framework of international trade law and WTO dispute-resolution mechanisms. #WTO, #FreeTrade and #multilateral dispute-settlement procedures might not sound like the most exciting battling cries in the age of #FakeNews. In terms of the likely impact on your portfolio for years to come, however, it may well be the most significant fight currently being waged on Twitter. And if you happen to disagree, I very much invite you to follow us on Twitter @DWS_CIO and let us know why.

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Glossary

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom of the European Union.

Correlation

Correlation is a measure of how closely two variables move together over time.

European Union (EU)

The **European Union (EU)** is a political and economic union of 28 member states located primarily in Europe.

North American Free Trade Agreement (NAFTA)

The North American Free Trade Agreement (NAFTA) is a trade agreement signed by Canada, Mexico and the United States, creating a trilateral trade bloc in North America, which came into force on January 1st, 1994.

Phillips curve

In economics, the Phillips curve is a historical inverse relationship between rates of unemployment and corresponding rates of inflation.

Republicans

The **Republican Party (Republicans)**, also referred to as Grand Old Party (GOP), is one of the two major political parties in the United States. It is generally to the right of its main rival, the Democratic Party.

World Trade Organization (WTO)

The World Trade Organization (WTO) is an international organization based in Switzerland, which regulates commerce between nations through mutually agreed rules.

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