Telling the truth on trade

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Summary

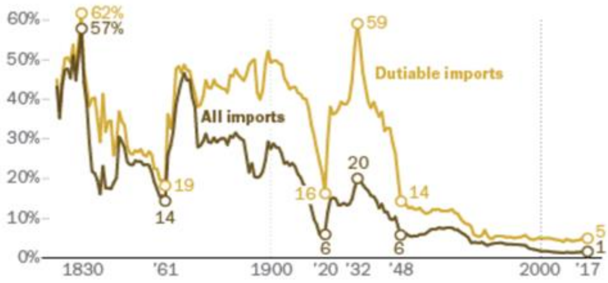
- US tariff-raising moves challenge the long-held conventional wisdom on free trade.
- We look at how trade has worked, focusing on the US-China trade relationship.
- Three trade 'truths' explain why we are where we are with such polarised opinions.
- The first trade truth is that free trade has unambiguously benefited both the US and China. Trade is no zero sum game.
- The second trade truth acknowledges the large number of 'losers' from greater trade openness. This has been a big factor in the growth of the anti-free trade voice.
- The final trade truth distances trade reality from trade theory. Real-life market conditions can support arguments for managed rather than free trade, even though such policies carry risks. The Technology market also has special attributes, which alter the debate.
- Given these trade truths, current anti free trade sentiment is unlikely to fade quickly. Eventually, the negative economics of higher tariffs could prove a challenge for the sceptics on free trade, but this could be a while coming.

Are new tariffs undoing 'free trade'?

The recent US tariffs on steel, aluminium and on some categories of Chinese imports and retaliatory measures from those impacted, have raised the spectre of escalating trade conflicts. While talk of a 'trade war' is exaggerated, there is no doubt that trade policy uncertainty is rising. The key risk is that it could get a whole lot worse looking ahead, given the tendency in trade conflicts for tariff moves to be met by retaliation.

From a free-trade purist standpoint, such interventions are anathema, 'lose-lose', against free trade which is 'win-win'. This post-war orthodoxy had until recently been a huge success in lowering direct barriers to free trade. Import duties/tariffs as a proportion of US imports had reached a negligible 1% (see chart). The average US tariff rate on dutiable goods has been in the low single digits with just a few exceptions.

Duties as a share (%) of the total value of ____, 1821-2017



Note: "Dutiable imports" refers to the value, as appraised by the U.S. Customs Service, of all imported goods that are subject to import taxes or duties.
Source: U.S. International Trade Commission; Federal Reserve Bank of St. Louis.

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It is true that this overstates the move to free trade. Many non-tariff barriers such as product regulation requirements from importers remain. Even so, it is clear that trend for many decades has been towards a lowering of trade barriers to a low level. Below, we call these conditions 'free trade' even though it is unlikely that it can be totally free in the way trade purists would like.

The US administration has made clear that it views the US as having been disadvantaged by the way such trading arrangements have evolved. Particular concern exists over trade with China. The new tariffs are directed at the areas (largely technology), where China has expressed an ambition to become a global leader by 2025.

Opinion is divided between free trade advocates and those who see current trading arrangements as unfair. When we look behind the scenes below to take a look at how free trade works, this polarisation of opinion becomes understandable. Three 'trade truths' explain why we are where we are. The bottom line is that the nuanced realities of free trade are such that we find a case to be made on both sides of the divide.

Trade Truth 1: Free(r) trade has benefited the US and China

Looking back at the move to freer trade over the past few decades, it is hard to argue that the US has not benefited very substantially. Imports from China have dramatically increased choice and lowered prices for a vast range of goods, greatly benefiting the American consumer. It has also helped US producers in many industries by lowering costs of intermediate goods. From the Chinese side, the benefits have been enormous. The move towards freer trade and China's deeper engagement with global trade since the early 1990s has been a dramatic success, lifting hundreds of millions of people out of poverty.

Poorer countries like China will derive a larger benefit from freer trade than rich countries like the US, but the first and most important truth on international trade is that both have gained. Yes, there is a large bilateral deficit that the US runs with China, but this cannot be seen in isolation. The total trade balance is more significant, but surpluses and deficits come from fluctuations in saving and spending trends in economies. Even a total trade surplus or deficit is no barometer of trading success or failure, let alone a bilateral one.

Trade Truth 2: There are a lot of losers from free trade

Free trade may have benefited both the US and China, but there is another reality, a second truth to confront, which is that it has also created a very large number of losers. In a very well-known 2013 paper[1] an attempt was made to quantify the scale of the impact on US manufacturing jobs from Chinese import competition. In just 15 years after China began its trade engagement with the global economy, the US employment share of manufacturing dropped by a third, the paper claiming that as much as 44% of the decline could be explained by the China phenomenon. Substantial job losses were identified as resulting from the China effect, estimated to be close to 1.5 million over 1990-2007. Imports from other lower income countries like Mexico would have added to this number. With limited and falling geographical mobility in the US from the 1990s onwards, the reduction in incomes in affected areas was large.

These employment losses and their large localised impact in lowering living standards are a grim reminder of the dark side of free trade. Income transfers to the affected areas were too small to make a difference.

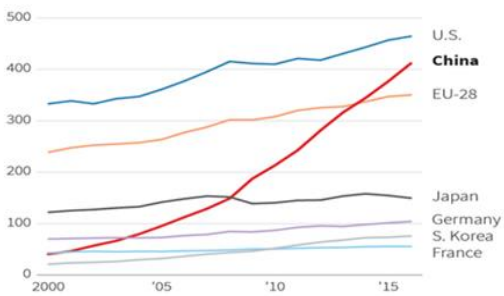
The key take away is this. Gainers from an open trading system outnumbered the losers in total, but a substantial minority were very adversely impacted. These effects continue. The US experience has also been replicated in a number of high income countries in creating worker displacement from trade openness. Globally, the ranks of losers have been large enough to create a vocal anti-free trade voice that has found growing political representation in the past decade.

Trade Truth 3: Models vs reality and technology as a special case

The classical arguments on free trade were built on theoretical foundations of highly competitive product markets with limited barriers to entry and where returns from size or scale fell beyond a certain point. Real life markets do not fit this mould. It is unclear if they ever did, but what is clear is that over time, they are increasingly characterised by the opposite. Generally, many markets have become less competitive in the US and elsewhere; there are substantial barriers to entry given the investment needed to establish market position; there are also large and increasing scale economies. While this has been good for investors given the protection it gives to profitability of established corporate players, it is less good for economies. Such market behaviour will naturally influence global trade's working.

Trade openness is still a win-win even under these conditions. Consumers still gain from more choice and lower prices regardless of who succeeds in these less competitive conditions. The complication is that there are typically other political or economic objectives that are in play than consumer interests alone. Governments may try and support home-grown companies or capabilities that succeed globally. Under the product market conditions noted above, there are potential benefits from guided intervention. While consumer interests remain in play, policy design can make it possible to balance the consumer against these wider national commercial objectives. This is exactly how China sees it. In fact, it continues a long East Asian tradition of governments building domestic industrial and technological capabilities in this way. Of course, such guided intervention has no guarantee of success and can in fact go badly wrong.

SPENDING IN R&D - In million U.S. dollars



Source: Organisation for Economic Cooperation and Development

R&D and innovation leadership is a good example. China's state-guided heavy R&D spending in many areas, from biotechnology to robotics, is well known and a key element of its Made in China 2025 strategy (see chart above). The more accurate description of trade under such

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[1] *The China Syndrome*, David H. Autor, David Dorn, and Gordon H. Hanson* American Economic Review 2013

intervention is that it is 'managed' rather than 'free'.

Technology is increasingly the testing ground in international trade for many of these reasons. 'First mover' advantages are large, there are major economic spill-overs from technology R&D spending and there are also several other conditions challenging free trade orthodoxy. Also supporting the line of thinking that says technology is a special case is that it is heavily intertwined with military/national security interests. Many technological innovations have already had a symbiotic relationship with military technology, and this tendency is now stronger than ever - cyber security is one modern example. The tendency to concentrate technological innovations into single global platforms adds to the difficulty in believing that competitive forces will prevail. All this explains current US sensitivity on China's growing technological capabilities, a key driver of the targeting of tariffs on China by the US.

Where does all this end up?

While the latest announcements may be understandable from the viewpoint of the 2nd and 3rd trade truths outlined above, this does not mean that more such intervention of the sort we have seen recently from the US will be successful. They carry a lot of risk. There are two obvious problems looming.

- First, tariff intervention will carry the big peril that some of the gains from free trade (Trade Truth 1) will be frittered away. If trade barriers keep rising this becomes much more likely.
- Second, higher trade barriers do not target losers under Trade truth 2 particularly well, in bringing enough job and income growth. Yes, the steel industry may be hiring more people in some of the rustbelt losing areas as a result of the new tariffs, but the overall gains will probably be small. In any case, the employment gains are likely to be smaller than employment losses elsewhere among steel users. (As an example, auto manufacturing, with its slim margins, will be put at a competitive disadvantage). If generalised tariff rises ultimately translate to higher shop prices, the free trade losers on lower incomes will be impacted heavily. This suggests that losers are better helped by more directed and larger income support, along with measures to encourage retraining and mobility.

Looking ahead, the trade issue seems unlikely to fade away quickly. At least some rise in trade barriers is becoming a higher probability. The difficulty with trading conflicts is that countries tend to respond to other countries' tariff moves by putting up their own. Of course, that way everybody loses.

Even though some newly protected industries and their employees will benefit, rising trade barriers will eventually make their presence felt in being bad for businesses and consumers in the aggregate. Thereafter, the argument for keeping trade barriers low can be made loudly and persuasively once again. The issue is that depending on how much trade barriers rise and how quickly at this time, this collective pain may not be evident for some time. Until then, trade conflict in some form looks likely to persist.

As far as markets go, they can live with some level of trade-related tension, but there will be a tipping point if escalation goes beyond a certain point. This is when sentiment and fundamentals are hurt significantly. We have not reached that stage, but on the basis of what we have seen in the past week, the probability of this happening is moving steadily higher.

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