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Protectionism and World Trade

By John Greenwood

Overview

- On May 14 US President Biden used Section 301 of the 1974 Trade Act to impose additional tariffs on imports to the US from China. He quadrupled tariff rates on Chinese electric vehicle (EV) imports, more than tripled the fees on Chinese lithium-ion EV batteries and doubled the levy on solar cells.

- Biden's tariffs on an additional $18 billion of Chinese products expand those previously imposed by President Trump in 2018 and 2019 on $300 billion of imports and are at least in part motivated by the need to counter Trump in swing-states such as Michigan and Pennsylvania at the polls in November.

- How significant is this for global trade? Since 2000 there have been five significant pauses in the upward march of global trade, three coinciding with recessions in the US, but two appear to be associated with policy-driven interruptions to globalisation. Today, sanctions are adding to the policy mix.

- Decomposing these slowdowns in world trade by country we can see that it is not only the two economies concerned that are affected, but other key economies are affected either by the tendency for allies to follow the same trade strategy or by the inter-connectedness of global supply chains.

- The purpose of this 11-page Newsletter is to review the consequences of these tariffs and related measures, as well as the retaliatory tariffs that China is likely to impose on imports from the US, on the health of US and global trade.

- An important parallel with the current round of tariff hikes is the action taken by successive US administrations in the 1970s, 1980s, and 1990s on Japan. The lessons of that episode are all too clear.

- Looking ahead it is highly likely that the effects on China will be similar to the effects of tariffs and restraints on Japan in the 1970s, 1980s and 1990s – i.e., diversion of trade through third countries and a move towards the production of higher value-added, wider profit margin goods at home by China, but no substantial change in the bi-lateral trade balance.

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The IMM Newsletter offers economic research written by John Greenwood, founder and Chief Economist of International Monetary Monitor. A pioneer of monetary research in Asia, John was also the publisher, editor and lead author of ***Asian Monetary Monitor****, a bi-monthly publication that he operated for 20 years from Hong Kong between 1977 and 1996. From 1999 to 2021 he was Chief Economist at Invesco, based in London. To access my research please email your request to* IMM@eri-c.com

Section 1: President Biden's New Round of Tariffs, 2024-26.

On May 14 the White House announced a series of tariffs and duties on Chinese-made products being imported into the US. President Biden proposed to quadruple tariff rates on Chinese electric vehicle (EV) imports, more than triple the fees on Chinese lithium-ion EV batteries and double the levies on solar cells and Chinese semi-conductors. The Administration would increase the tariff on steel and aluminium products from 7.5% to 25%, and a new duty on shipping cranes would be set at 25%. Critical minerals and medical products were also targeted. These tariff increases, among others, will kick in this year, while others, including a tariff increase to 25% from 7.5% for larger storage batteries and a new tariff on natural graphite will take effect in 2026, allowing US manufacturers time to re-arrange their supply chains.

The White House estimated that the tariffs would apply to $18 billion of Chinese imports, extending the range of tariffs imposed by the previous Trump administration on $300 billion worth of Chinese imports. In contrast with the Trump measures, the Biden staff claims that their measures are aimed at protecting specific sectors. These include electric vehicles, semiconductors, solar panels and other industries where China is dominant, but the where the Administration has already committed to spending billions on new domestic manufacturing capacity.

Aside from its rivalry with ex-President Trump, the Biden Administration has seemingly been goaded into action by measures taken in China to offset the slump in the Chinese economy, shifting activity from housing and real estate development to manufacturing and exports. According to the New York Times, "From tariffs to technology bans to concerns about TikTok, the Biden administration has been cracking down on China, which, it says, is abusing longstanding commercial relationships, subsidizing local industries directly and indirectly, obtaining U.S. intellectual property illicitly and fundamentally threatening US national security."[1] Chinese officials have doubled down on production in industries very similar to those the US was targeting. The fear among Biden administration officials is that Chinese manufacturing is powerful enough to lower prices globally, undercutting nascent US companies and eroding the value of the Biden administration's subsidies. How significant could these tariffs be in terms of (a) philosophy and (b) GDP and economic activity?

First, they clearly indicate that both Republicans and Democrats are well along the path towards abandoning the neo-liberal Washington consensus of recent decades. This was a set of ideas that trade liberalization (or free trade), the avoidance of subsidies, private ownership of businesses and assets protected by the rule of law, deregulation, floating and therefore competitive exchange rates, coupled with open capital markets, macroeconomic stability, balanced budgets and fiscal prudence were the best way to raise incomes around the world – whether in richer or poorer economies.

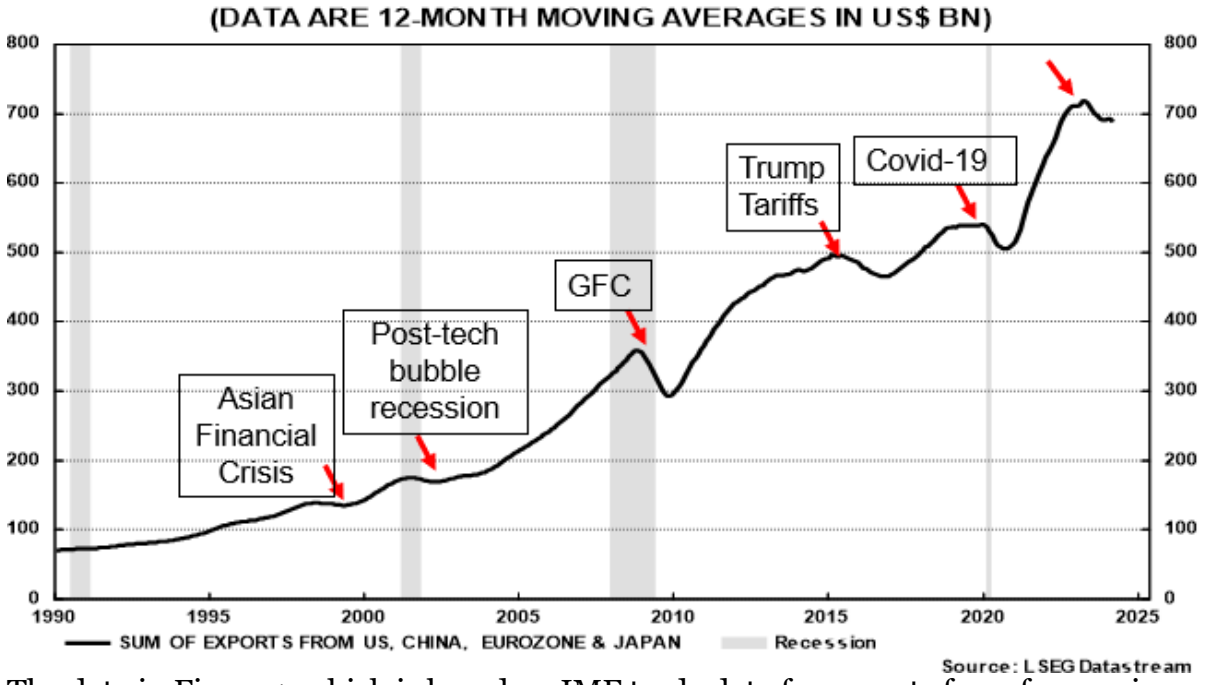
[1] Jeff Sommer, The Business Ties that Bind the US and China are Strong but Fraying, NY Times, 2024/05/24.

So pervasive had these concepts become that that they became part of the conditions laid down by the IMF for bailing out crisis-hit economies. Organisations like the GATT (later converted to the WTO) or the EU and NAFTA incorporated many of these principles into their founding statements.

However, as "rules of the game", the ideas also depended critically on every nation playing by the rules, especially the larger nations or groupings such as China, the US, and the EU. Many have accused China of not playing by these rules. But in recent years there has been growing evidence, especially after the GFC and Covid-19 crises, that developed western economies have given substantial handouts to farmers, manufacturers, and service providers. Many of the advantages given to industries are often hard-to-spot subsidies such as cheap loans or tax breaks. Governments have engaged in this type of subterfuge because it has enabled them to maintain a veneer of trade respectability while tilting the playing field in favour of selected, influential companies or other interest groups (farmers, trade unions, etc.). A bottom-up study by the Global Trade Alert group on known, documented cases estimated that two-thirds of world trade in goods is currently influenced by subsidies to local companies and exporters. As yet, there is no agreed metric for measuring these interventions.

Second, how significant are they for real GDP and economic activity?

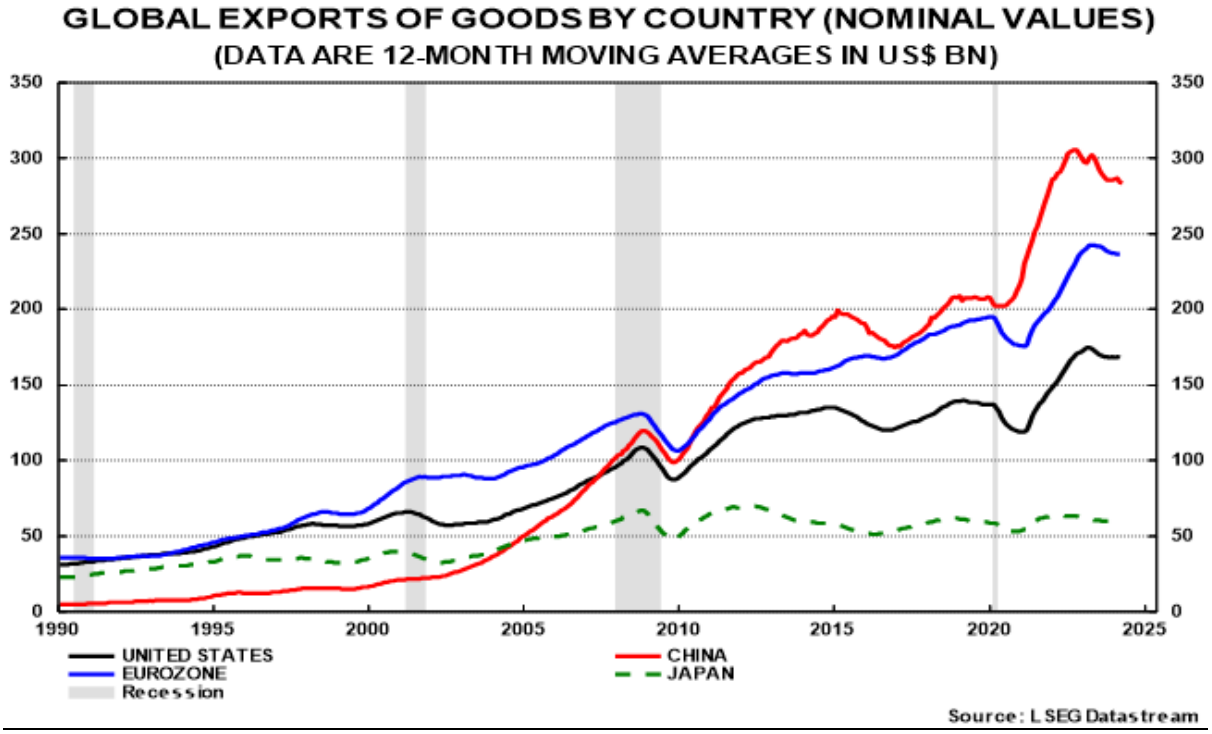
Figure 1. Global Trade Declining in Nominal US$ Terms



The data in Figure 1, which is based on IMF trade data for exports from four major blocs, shows there have been five significant slowdowns or downturns of global trade measured in nominal US$ since the Asian Financial Crisis of 1997-98. Three of them were associated with US recessions (the grey vertical bars in Figure 1): the US recession of 2001-02, the GFC, and the brief Covid-19 recession. Among the other two, trade clearly slowed in 2016 – ahead of the imposition of the Trump tariffs in 2018-19 – and the current downturn may be explicable in terms of the downturn in

the EU due to the Ukraine war and the sanctions on Russia, together with strong US domestic demand and the appreciating US$ which is hurting US exports.

Figure 2. US & China Main Contributors to Export Downturns in 2016 and 2023-24.

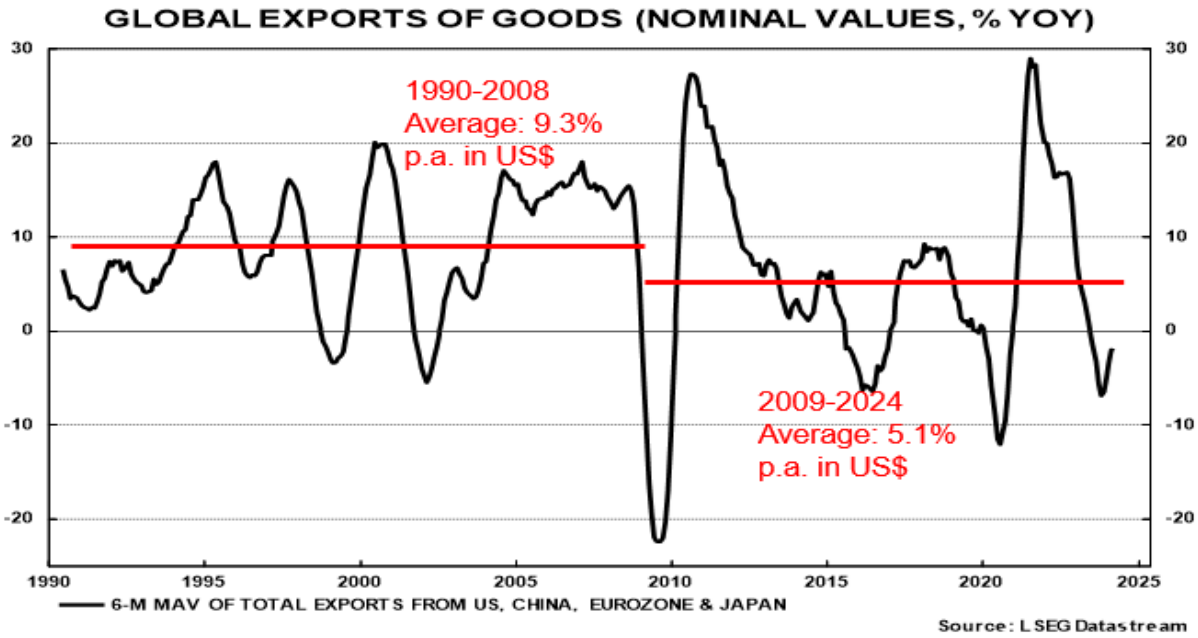


Disaggregating the total exports in Figure 1 into country data in Figure 2, we can see that export downturns in the US (in black) and China (in red) played large roles in the two non-recession slowdowns. The EU (in blue) played a much smaller role in the 2016 slowdown but is slowing as much as the US in the current downturn. Finally, Japan's exports (in green) fluctuated relatively less in both 2016 and 2023-24.

During the years 1990-2008 the average annual growth of world trade in US$ was 9.3% p.a. However, after the GFC in the years 2009-2024 the growth rate of global trade (in US$) nearly halved to just 5.1% p.a. (Figure 3).

In recent years trade restrictions have been supplemented with various types of sanctions – normally imposed for foreign policy or national security reasons. In the US case, these sanctions include economic, diplomatic, and military sanctions currently imposed on 28 countries (ranging from Afghanistan, Belarus and Cuba to Iran, Myanmar, Sudan and South Sudan, and Venezuela) and some 6,300 individuals. The enforcement is conducted by OFAC, the Office of Foreign Asset Control, which is an agency of the US Treasury. By far the largest and most significant target of US sanctions is Russia. The EU and UK have also imposed wide-ranging sanctions on Russia, but there are many gaps in the framework enabling Russia to sell raw materials to major economies such as India and China, and to purchase military supplies from Turkey, China and elsewhere. Payments and settlements in non-USD currencies have also increasingly frustrated US aims.

Figure 3. The Annual Growth of World Trade in US$ Terms almost Halved after the GFC.



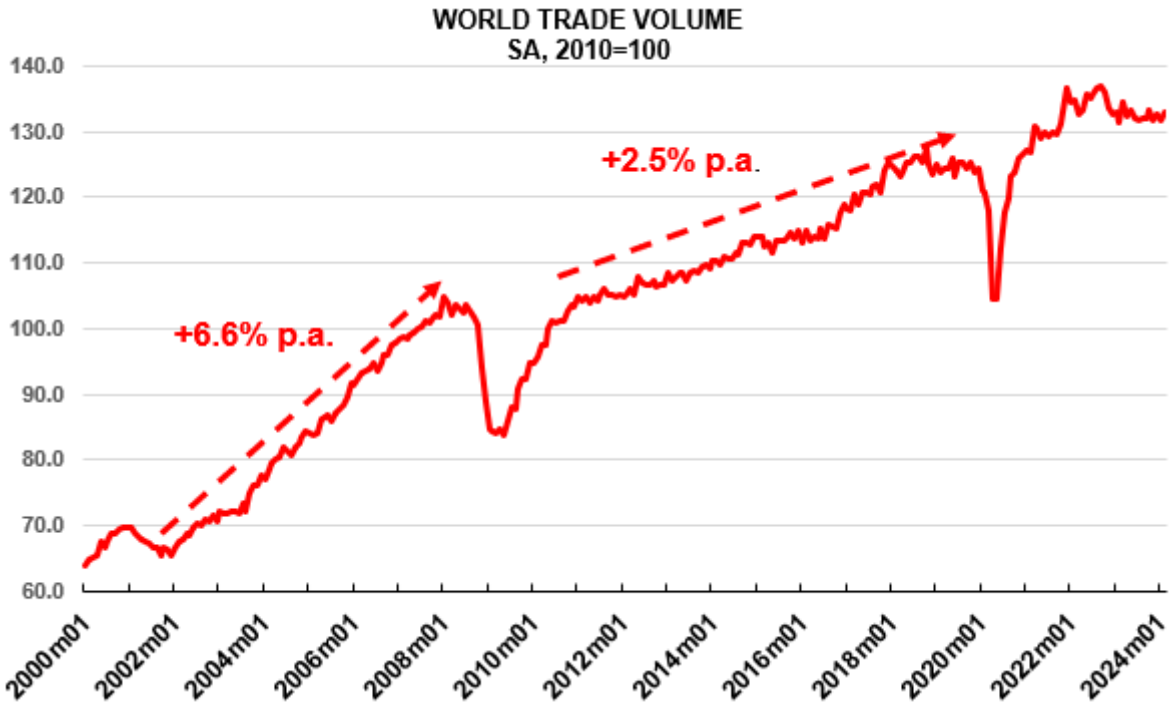
Section 2. Trade Data by Volume and Price (Unit Value)

The Netherlands Bureau for Economic Policy Analysis (CPB), founded in 1945 by Dutch economist and Nobel laureate Jan Tinbergen, now forms part of the Netherlands Bureau for Economic Policy Analysis. The CPB collects data on world trade in volume and price (unit value) terms and is accessible to all.[2] The data for the charts in this section all come from this source. In contrast to the US$-based figures for the four major areas quoted in Section 1, these data are fully global.

Even a casual study of the data in Figure 4 shows how the growth rate of world trade slowed after the GFC, and, following the immediate post-Covid recovery, has effectively stopped growing since late 2022. Between 2002 and October 2008 world trade volume grew at 6.6% p.a., slowing to 2.5% p.a. in the post-GFC period 2011-2019. After the immediate post-Covid recovery, the CPB volume index peaked at 134.1 in September 2022, but the latest CPB figure for March 2024 is 130.5, down 2.7%. It is probably too early to declare a sustained or indefinite flattening out of world trade volume but, given the frictions between major nations in the world trade and geo-political arenas, the omens do not look good.

[2] See https://www.cpb.nl/en/world-trade-monitor-march-2024

Figure 4. World Trade in Volume Terms has Stalled.



Turning to the prices for global exports, there have been at least three major upswings in US dollar terms since December 2001 when China joined the WTO (Figure 5, PTO).

First, between February 2002 and October 2008 the double-digit real GDP growth of China set off what has come to be known as the "commodity super-cycle" – a period during which China's demand for basic commodities was so strong and so far-reaching that the majority of all traded goods increased in value. The CPB price index for exports increased by no less than 69.8% over this period, culminating in a sharp upward spike in prices between January 2007 and October 2008 of 15.8% (included in the 69.8%).

The second upsurge in prices was also prompted by China and lasted from November 2008 until August 2011. The jump in prices occurred because China's banks, which had not been damaged by the sub-prime crisis in the US or the property downturn in parts of Europe such as the UK, Spain, Ireland and Greece, participated in the huge CNY 4 trillion stimulus policy engineered by the Chinese authorities from November 2008. The effect was to double the rate of M2 growth from about 15% to nearly 30% over two years, resulting in an enormous expansion of Chinese domestic demand – enough for China, single-handed, to drive up global commodity prices even though western economies remained stuck in recessionary conditions.

Figure 5. Surges in the Price of World Exports, 2000-24.

Omitting a relatively mild price upswing in 2016-18, the third global export price surge was prompted by the post-Covid recovery. This time the price surge in global exports reached 36.7% in US dollar terms (Figure 5) between April 2020 and June 2022. Like the 2008-11 price surge, this was again driven by monetary expansion, only this time it was led by rapid broad money growth in the US, the eurozone, and the UK, plus Canada, Australia, and New Zealand. China did not participate in the monetary expansion so its demand for imports remained subdued and its domestic inflation was negligible. (These facts show that those who have argued that the inflation of 2021-24 was either global or due to exogenous shocks have been wrong. Inflation is not only a monetary phenomenon, but also a local one).

Section 3. The Lessons of US Trade Restraints Imposed on Japan in the 1970s, 1980s, and 1990s.

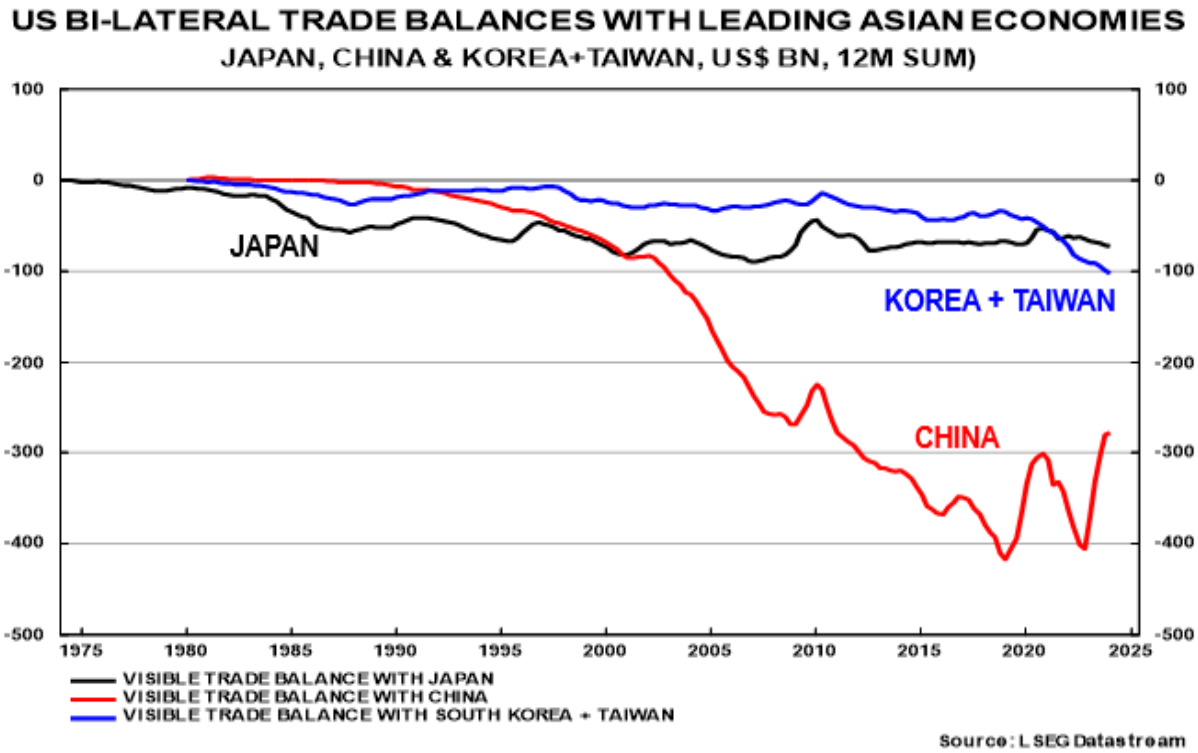
Current trade disputes between the US and China evoke memories of the prolonged trade frictions between the US and Japan in the 1970s, 1980s, and 1990s. During these decades the US and Japan were involved in trade frictions focused on a number of products including textiles, steel, automobiles, semi-conductors, and agricultural products.

US–Japan trade frictions basically took two forms: (i) the US attempting to restrict Japan's exports to the US; and (ii) the US attempting to increase its exports to Japan by "opening" the Japanese market. By putting pressure on Japan to adopt "voluntary restraints" on exports (amounting to a tariff exceeding 60% according to one study) and enhance US access to Japan's domestic markets, the US sought to achieve two

main objectives: (i) to reduce its trade deficit vis-à-vis Japan; and (ii) to protect and/or promote US industries.

Despite prolonged negotiations and over 100 agreements or joint communiques, the US failed to achieve the first objective, while only modest success was achieved for the second objective.

Figure 6. US Trade Deficits with Asian Economies have Persisted.



The United States was able to exert great pressure on Japan at the time because it was both Japan's major overseas market — by a long shot — and its geopolitical defender against the Soviet Union. There was also no World Trade Organization (WTO) to constrain unilateral moves at the time. Bowing to pressure from the United States, Japanese trade negotiators agreed to a whole constellation of agreements designed to limit exports of steel and cars to the US, expand imports from the US, and eliminate "barriers" to the success of American firms in the Japanese market.

Trade negotiators cooked up a whole alphabet soup of deals – agreements, Memorandums of Understanding, joint announcements, and communiques in the 1980s and early 1990s. There were Voluntary Export Restraints (VERs) on steel and autos, Voluntary Import Expansions (VIEs) like the US-Japan Semiconductor Trade Agreement of 1986, the so-called Market Oriented Sector Specific (MOSS) negotiations that covered five sectors under Reagan, and the Structural Impediments Initiative (SII) begun under Reagan's successor, George H. W. Bush.

The continuous on-off trade negotiations with Japan were regularly in the financial headlines. Tariffs, quotas, and so-called voluntary restraints on exports all featured in the many agreements. These measures were widely publicised. But anyone who

studies trade theory learns that one of the consequences of protectionist measures is "trade diversion". While in the textbooks this typically meant shifting the production from low-cost Asian countries to a high-cost country such as the US and ending up with lesser trade volumes, in practice parts of the manufacturing process have often been relocated from the target economy (Japan) to lower cost economies in Asia (such as Taiwan, Malaysia, Vietnam etc, or more recently Mexico). In other words, the supply chain was diversified.

Another result, less widely documented, was that if Japan was prevented from attaining its full potential in, say, textile or steel exports, it's activity would shift to higher value-added products such as autos, semi-conductors, and robotics etc where the profit margins were often higher – at least initially – and those profits were protected by a greater "moat". China is likely to react in exactly the same way.

Another avenue for Japan to avoid trade restrictions was to invest directly in building manufacturing plants (e.g. in the auto industry) located in the United States.

The US trade war with China has similar objectives as the US trade negotiations with Japan: (i) reducing the bilateral trade deficit; and (ii) stopping unfair trade practices by Chinese firms such as violations of intellectual property rights and forced technology transfer. However, based on the experiences of the US–Japan trade frictions of the past several decades, the US may achieve some success for the second objective, but not for the first. As Figure 6 (above) shows, already the bilateral trade deficit with China is already 3-4 times the size of the largest deficits ever experienced with Japan, and the combined balances with South Korea and Taiwan already exceed those with Japan.

One reason why decades of tough trade diplomacy with Japan - a vulnerable trading partner - failed to shrink the deficit was that those trade measures did not address the underlying economic conditions that were contributing to higher levels of imports over exports. The record peacetime budget deficits of President Reagan's first term were not matched by an increase in private savings or a drop in private-sector investment.

The reason that Japan and now China have had huge trade surpluses is that it is ultimately domestic policies that generate the external balances. US trade policy did not change the external trade balance of Japan because the US did not change its domestic savings rate, and it will not change China's either because China's domestic savings balance is unlikely to be changed by any interaction with the US. China's external balance will only change after an increase in Chinese consumption and decrease in its rate of savings.[3]

By definition, a country will have a current account deficit if the sum of government budget deficits and private investment are greater than its private savings. When a nation saves less than it invests, the shortfall in savings must be supplied by foreigners who lend to that nation. Much like a household that is spending more than

[3] https://www.cato.org/sites/cato.org/files/2019-10/hanke-strange-word-trade-wars-2019.pdf

it is earning will buy more than it makes, a nation with higher levels of investment than savings will be buying more from abroad than it sells to other countries.

The failure to reduce the US trade deficit with Japan implies a need to be cautious in expecting any substantive results from negotiations with or measures taken against China. First, America's leverage in negotiations is lower now than in the 1980s: the end of the Cold War has removed the geopolitical leverage America once had over nations like Japan (although a Cold War with China cannot be ruled out). Second, the US share of her trading partners' exports has declined sharply. But even in the 1980s, the effort to reduce the trade deficit through trade policy did not work.

The chances of achieving the second objective (stopping unfair trade practices) would increase if the US were to cooperate with countries such as Japan and the European Union, which are faced with similar problems vis-à-vis China. But recent leadership styles (under Trump and Biden) have emphasised putting US interests ahead of any effort to reform the international order in trade or any other sphere.

Summary and Investment Conclusions

- On May 14 US President Biden used Section 301 of the 1974 Trade Act to impose additional tariffs on imports to the US from China. He quadrupled tariff rates on Chinese electric vehicle (EV) imports, more than tripled the fees on Chinese lithium-ion EV batteries and doubled the levy on solar cells.

- Biden's tariffs on an additional $18 billion of Chinese products expand those previously imposed by President Trump in 2018 and 2019 on $300 billion of imports and are at least in part motivated by the need to counter Trump in swing-states such as Michigan and Pennsylvania at the polls in November.

- It is too early to be confident about the outcome, but already world trade appears to be slowing. Unless this is an early sign of impending recession in the US, the slowdown appears to be consistent with another policy-driven interruption to globalisation.

- An important parallel with the current round of US tariff hikes on imports from China is the action taken by successive US administrations in the 1970s, 1980s, and 1990s on Japan. However, Japan was only ever a commercial threat to the US. Today, China is viewed as both a commercial and a strategic threat to the US, and therefore the countermeasures taken are more far-reaching and could include more sanctions.

- The lessons of the historic episodes of trade friction with Japan are all too clear. The US failed to narrow the bilateral trade deficit; failed to restore those domestic industries that had been threatened by foreign competition; and Japan simply re-directed its effort to upgrading its skills and investment in other, higher-valued industries, and investing in manufacturing in the "target" economy (the US).

- Looking ahead it is highly likely that the effects on China will be similar to the effects of tariffs and other measures on Japan in the 1970s, 1980s, and 1990s – i.e., diversion of trade through third countries and a move towards the production of higher value-added, wider profit margin goods at home by China, but no substantial change in the bi-lateral trade balance.

- The investment implications are (1) that sector-specific equity exposures in the US will not be rescued by any inter-governmental trade or other bilateral negotiations, and (2) that global trade and sales growth in future years are likely to be slower even than in the post-GFC period.

- This means also (3) that a sustained boost to commodity prices – as occurred following China's big stimulus policy in 2008-12 – is highly unlikely to be repeated.

- (4) The main beneficiaries are – and are likely to continue to be – so-called "connector countries" such as Mexico and Vietnam which will continue to benefit from the diversion of investment (e.g. in assembly operations) from China to these "stepping stone" economies that will have easier access to the US domestic market.
