

Trade War: “An Enemy to All Mankind”

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The military metaphor is almost cliché: President Trump has declared a trade war against China and other countries, launching salvos of tariffs designed to shrink our bilateral trade deficit and to curtail what he perceives as unfair trade practices – or at least to bring a weakened adversary to the negotiating table. The metaphor is apt, inasmuch as the imposition of tariffs can seriously impair a nation’s economy.

The relevant question is *which* nation’s economy is adversely affected by a trade war, and the unfortunate answer is *all of them*. As Edwin Starr chanted about a different kind of conflict, “*War – what is it good for? Absolutely nothing! It ain’t nothing but a heartbreaker ... an enemy to all mankind.*” So too with a trade war. Indeed, analysts at Empirical Research Partners recently revived the phrase “mutually assured destruction” to refer to the potential impact of President Trump’s proposed tariffs on the economies of both China and the United States.¹

If the tariffs on \$50 billion of imports from China go into effect on July 6 as scheduled (and if tariffs on a further \$200 billion follow later this summer in the event of Chinese retaliation), they will represent the first serious imposition of trade barriers in decades – and certainly the first in the current era of global supply chains. That distinction matters greatly, because our economy is much more deeply intertwined with China’s than ever before. Attacking alleged unfair trade practices with tariffs makes as much sense as injecting penicillin into laptops to cure computer viruses, and the results would be just as counterproductive: The penicillin would probably short out the computer’s circuitry, and tariffs would likewise scramble our domestic commerce. Just because penicillin or tariffs were effective cures for problems in the past is no reason to assume they would be effective on different (albeit similar-seeming) problems today.

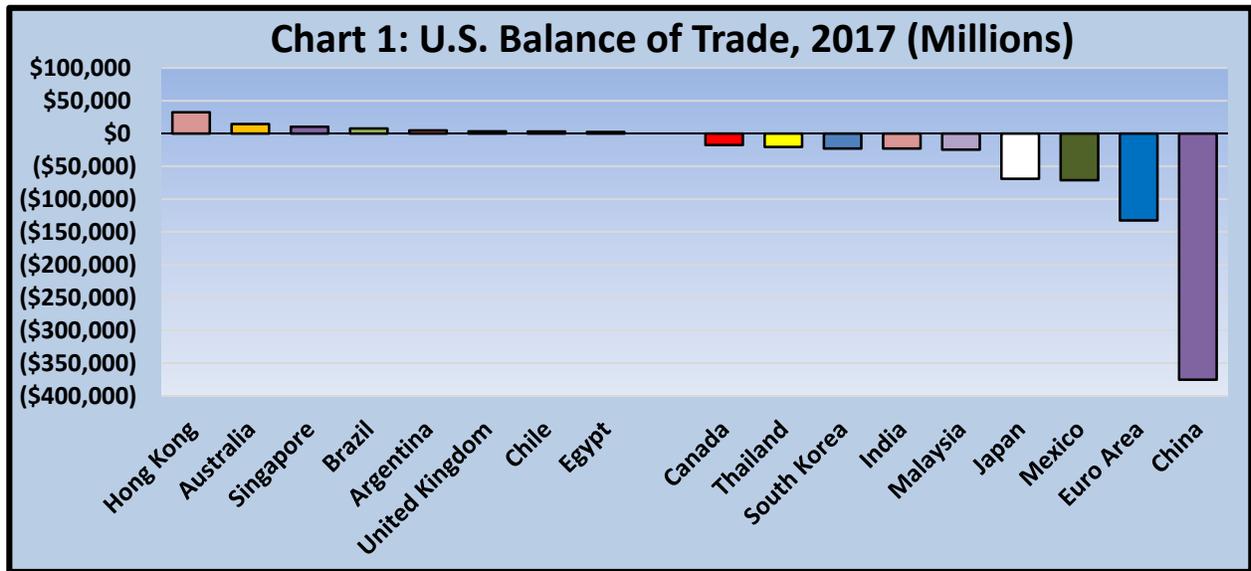
The problem: Unfair trade practices

Global free trade is an unequivocally good economic principle. It creates economies of scale, leads to more efficient capital deployment, removes barriers to productivity, lowers costs of production, and creates interdependencies that can defuse political conflicts. Free trade is the single most powerful tool available to boost productivity and therefore economic growth.

In a global free trade economy, a balance of trade deficit or surplus with any individual country is an irrelevant statistic. The U.S. will export more than it imports to some countries, and vice versa, depending on where individual goods and services are most efficiently produced; everyone wins when overall costs are lower. Imposition of regulatory controls (such as tariffs designed to equalize bilateral trade flows) only raises costs and impedes economic growth.

¹ Michael Goldstein, “A U.S. / China Trade War,” published June 20, 2018, at www.empirical-research.com.

Chart 1 shows that the U.S. had a \$375 billion trade deficit with China last year (\$505 billion of imports against \$130 billion of exports), far greater than that with any other country. The deficit, big as it is, isn't by itself a concern. If China engineered that imbalance through unfair trade practices – forced technology transfers, patent violations, limits on capital flows, government subsidies, industrial espionage, and other nefarious means – then the U.S. would have a legitimate cause for retaliatory action. Enough evidence exists to suggest that at least some of China's trade surplus has been amassed unfairly; the relevant question is how to respond.



Source: Census Bureau

The wrong solution: Tariffs

From the onset of the Industrial Revolution until recently, if one country could produce widgets more cheaply than another, trade became profitable when the cost of transportation fell below the production cost differential; the primary driver of trade was therefore the steady fall in the cost of transporting physical goods. In a trade skirmish, higher tariffs could thwart global trade because they erased the benefits of lower transportation costs. The results were inevitably higher prices and lower demand; the hope was that these negative effects would be temporary and offset by an increase in sales by domestic companies protected by the tariff. That tradeoff rarely worked well.

A tariff regime would be even more destructive to our own economy today because of the revolution in communications that drove economic growth beginning in the 1990s. The deployment of vast telecommunications networks and the broad adoption of the internet meant that *information* and *capital* could now be sent around the globe as easily as physical goods; this led to the creation of global supply chains in which the site of innovation could be thousands of miles distant from the site of manufacturing.² In this environment, multinational corporations have invested heavily in foreign countries to control their supply chains while reducing costs.

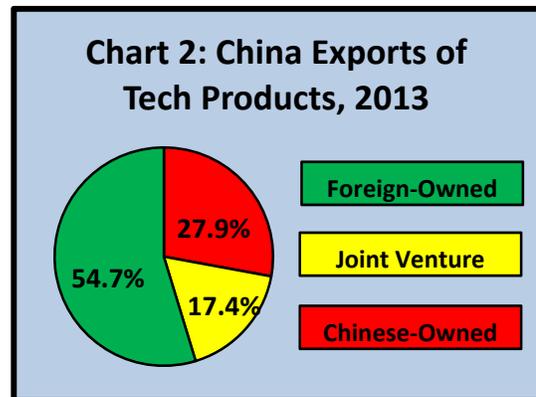
² I encourage you to read *The Great Convergence*, by Richard Baldwin (published in 2016 by The Graduate Institute in Geneva) for a lucid elaboration on this theme.

When American multinationals outsource their manufacturing jobs to Chinese affiliates, they still create far more American jobs in product design, manufacturing innovation, marketing, finance, and other high-skill fields.³ This phenomenon has been evident in the ongoing controversy over ZTE, a Chinese telecom firm that the Trump administration initially tried to ban from selling to American customers; the administration reversed itself when it learned that ZTE was itself one of the most important customers of San Diego-based Qualcomm, one of this country’s most important semiconductor design firms.

Raising tariffs today would hurt Americans in manifold ways: U.S. firms would lose sales by their foreign affiliates to American customers; they would also become *less* competitive against global peers because only American companies would be forced to pay these tariffs on their imported inputs. Indeed, it’s even plausible that some American companies might relocate to other countries specifically to avoid paying the Trump tariffs, thereby destroying American jobs. American consumers would also suffer, paying higher prices for American products that passed through foreign countries at some stage of their production.

These effects would be true of *any* tariff regime imposed on imports from a foreign country; they are as applicable to Canadian timber as they are to Chinese computers. But the details of President Trump’s proposed China tariffs are especially troubling, because the targeted industries and products are aimed directly at the most vibrant sectors of the American economy: technology and industrial equipment. A recent study by the Peterson Institute for International Economics⁴ paints a deeply disturbing picture of the proposed tariffs on imports from China:

- Fully 60% of China’s total exports to the United States were produced in China by companies owned at least in part by foreign (non-Chinese) affiliates. The data is not sufficiently granular to determine specific domicile of these non-Chinese entities, but in aggregate the owners are primarily based in the U.S., Japan, South Korea, and Europe – all of which are American political and economic allies. As Chart 2 shows, the extent of non-Chinese ownership of *technology* exports is even higher: Only 27.9% of China’s 2013 (latest data available) tech exports came from Chinese firms, while more than half came from companies entirely owned by foreigners. The Trump tariffs would essentially be taxing ourselves and our allies, not China.



Source: Peterson Institute

³ Theodore Moran and Lindsay Oldenski noted in a 2016 Peterson Institute report: “Domestic production would not be as strong as it is without access to global supply chains, which reduce costs, raise productivity, expand the global market share of U.S. firms, and allow the United States to focus on what it does best: innovating, researching, and designing the cutting edge goods and services of the future.” The report, “How Offshoring and Global Supply Chains Enhance the Global Economy,” is available at www.piie.com; look for PIIE Policy Brief 16-5.

⁴ Mary E. Lovely and Yang Liang, “Trump Tariffs Primarily Hit Multinational Supply Chains, Harm US Technology Competitiveness,” published May 2018, and available at www.piie.com; look for Policy Brief 18-12.

- Three types of products account for 54% of American imports from China: Computers and cell phones; electrical equipment, and machinery. These particular fields generate more U.S. patents per employee than any other sectors of our economy; in other words, we design the products here and reap the profits from that intellectual property here, even when manufacturing or assembly is in China. Ripple effects from tariffs on these items could impair some of our most dynamic industries.
- The Trump tariffs would be imposed only on imports to the United States. Manufacturers based in other countries would be unaffected, and therefore would gain a competitive edge against American companies.
- The focus on electrical and other machinery means that “capital goods” (production equipment) would account for 43% of the targeted tariffs, with parts and accessories constituting another 29%. Almost three-quarters of the tariffs would affect our ability to make and sell downstream finished goods that may be in entirely different industry sectors; this is a second-order effect that suggests that the adverse impact on our economy would be felt far more broadly than just in the directly targeted industries.

The Peterson Institute report is depressing enough: It demonstrates that the Trump tariffs would attack our most vibrant domestic industries, send capital and jobs overseas, raise domestic prices, and harm our global competitiveness. Empirical Research Partners went a step further, showing that these tariffs would punish American investors through their leveraged impact on the U.S. stock markets. Chart 2 shows that manufacturers represent only 12% of U.S. GDP and only 8.5% of private non-farm jobs, but they represent 43% of the earnings of the S&P 500 index. The targeted industries are among the most richly valued American stocks, so an earnings shock could have a surprisingly large negative impact on stock prices and 401(k) savings.



Source: Enterprise Research Partners

Worse, the tariffs wouldn't hurt China and wouldn't fundamentally change China's trade practices. China could as easily sell the targeted goods to customers in other countries. Taking this a step even further, China's potential retaliation would likely be to impose similar tariffs on American exports – which are mainly agriculture and commodities. These products are currently cheaper coming from the U.S., but they are widely available worldwide. If China imposed tariffs on American wheat, Chinese customers could still buy wheat from many other countries at only slightly higher prices; but the pain to U.S. wheat producers would be significant. In this way, the effect of a trade war would likely be highly asymmetric: American tariffs on Chinese imports and Chinese tariffs on American imports would both hurt Americans without really affecting China's trade practices. That way lies madness.

The better solutions: Negotiation and education

The Trump administration may view its escalating series of tariff announcements as an implementation of the Prussian soldier Carl von Clausewitz's maxim that war is the continuation of politics by other means. But self-immolation rarely accomplishes its desired goals. A better guiding principle is to combine diplomatic negotiation with substantive changes to our domestic economic policy.

What matters here is not that China has a big trade surplus with the U.S., but that China's trade practices have been unfair. Diplomacy can be a powerful tool to address this issue, in the hands of adept practitioners. Turning back to the ZTE example, the Trump administration inadvertently and clumsily proved that it has muscle to change China's behavior; it could effectively have put ZTE out of business by preventing that firm's access to the U.S. market.

Acting more adroitly, the U.S. can adopt and enforce carefully structured limitations on how American companies operate in China, thereby limiting China's access to American technology and innovation unless China loosens its own trade rules. In a globalized economy, effective trade negotiation revolves around access, intellectual property, information, and capital; all of these can be used in the service of more equitable trade practices.

This is exactly the theme of potential new actions that the White House economics team is currently considering, according to a report in the Wall Street Journal.⁵ The administration may block firms with at least 25% Chinese ownership from investing in American technology companies, and it may also stop American exports of some key technology products to China. These are measured steps; the investment ban doesn't attempt to unwind existing joint ventures, for example. They are far more likely to affect China's ability to trade unfairly than tariffs would, and would cause less disruption to the American economy.⁶

At home, the U.S. economy has grown substantially as global supply chains have taken root. But the growth has disproportionately favored the owners of capital, innovation, and intellectual property: That is America's value-added contribution to the global economy today. While global trade has undoubtedly destroyed U.S. manufacturing jobs, it has also created a many more, in high-skill (and high-pay) disciplines such as R&D, engineering, design, logistics, marketing, and others. Rather than vainly trying to restore old jobs where we can't be competitive anyway, our economic policy should be focused on education and training for the new types of jobs.⁷

⁵ "Trump Plans New Curbs on Chinese Investment, Tech Exports to China," by Bob Davis, first published online at www.wsj.com on June 24, 2018.

⁶ Circling back to Edwin Starr, *any* trade war is worse than *no* trade war, but limited and targeted actions such as these can help restore equilibrium without cascading into a wider trade conflict.

⁷ It's not as if the U.S. economy has any difficulty creating jobs, after all. The number of job openings has tripled in the past decade to more than 6 million. The U.S. now has more job openings than unemployed workers; the problem is the mismatch of skills and location, not the absence of opportunities. That's why training and education – both for workers displaced by a changing global economy and for young people just entering the work force – are so important to our future economic growth.

Richard Baldwin, in *The Great Convergence*, argues that the path forward needs to focus on *workers*, not *jobs*. A better economic policy today would accept the effects of globalization, and help workers displaced by technology and offshore manufacturing; that help can come in the form of retraining for the jobs that are abundant here; in mobility support to make it easier for families to relocate when better jobs are available in other cities; and in sponsorship of industry “clusters” such as Silicon Valley or Wall Street or Hollywood, places where many competitors can mutually benefit from a large and skilled workforce. These sorts of ideas can be political winners for the Trump administration if they are promoted as programs designed to insulate our economy from the negative aspects of global trade while also making our products and services more globally competitive, and putting more Americans to work.

Ultimately, economies can only grow sustainably by two means: more workers, or more productivity. The surest way to increase the work force is to welcome more immigrants, but that’s another story for another day.⁸ Productivity (output per worker) is much harder to improve by political means, but free trade is the best tool available. In a world of free movement of capital and ideas across national borders, the American economy will thrive best when it likewise benefits from freer flow of people and goods across our borders as well.

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⁸ A very good place to start that discussion is “Our Real Immigration Problem,” an op-ed column by Bret Stephens in the New York Times, June 21, 2018.