

# The Free Trade System Facing the Threat of Collapse\*

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## Abstract

Triggered by the United States imposing tariffs on Chinese imports and subsequently China's retaliatory action, the exchange of tariffs has escalated into a full-blown trade war between the two countries in 2018. The United States is aiming to reduce or eradicate its trade imbalance by using protectionist measures. There are two main reasons behind protectionism in the United States. One is an attempt to secure jobs in certain sectors of US industry. Another reason is the alarm it feels in the face of China's rapid development in information technology (IT) and other areas of advanced technology. The latter concern is shared by many members of the US Congress and business leaders, and this makes it possible that measures against China may continue long beyond the Trump presidency. I propose three options that the rest of the world can take in these circumstances to persuade the United States to return to a rule-based free trade system: (1) a possible U-turn in US policy would be brought about by the increasing severity of the negative impact of protectionist measures on the US economy itself; (2) the world's major economies—Japan, the EU, China, and so on—to work toward comprehensive and liberal regional integration without the United States on trade and investment, and thus push the United States into a disadvantageous position; and (3) countries that share interests in common, like Japan and the EU, to involve the United States in efforts to reform the World Trade Organization (WTO).

## Protectionism and the Outbreak of a US-China Trade War

In March 2018, US President Donald Trump imposed additional tariffs on imports of steel (25%) and aluminum (10%), based on Section 232 of the 1962 Trade Expansion Act (national security). He is currently considering imposing additional tariffs on motor vehicle imports. Meanwhile, in July 2018, citing infringements of intellectual property, he used Section 301 of the 1974 Trade Act (unfair trading practices on the part of a foreign government) to slap tariffs (25%) on Chinese imports worth \$34 billion. China retaliated by imposing tariffs (25%) of its own on imports from the United States to the same amount. Riled by China's retaliatory action, the United States imposed further tariffs on Chinese imports worth \$16 billion in August, prompting China to retaliate by slapping additional tariffs on US imports worth the same amount. In September, the United States and China both implemented a third round of tariffs. The United States slapped tariffs on \$200 billion worth of imports from China, while China imposed tariffs on US imports worth \$60 billion. Following these three rounds of tariffs, the total value of affected US imports from China is around \$250 billion; around \$110 billion of Chinese imports from the United States are affected by Chinese tariffs. This is equivalent to roughly half of all US imports

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from China, and approximately 85% of the goods that China imports from the United States on a value basis. The exchange of tariffs has escalated into a full-blown trade war between the United States and China.

In addition to the trade war it started with China, the United States is aiming to reduce or eliminate its trade imbalance by using protectionist measures through bilateral talks with countries with which the United States has a trade deficit. These policies are based on the idea that a trade imbalance indicates an excess of imports over exports, and that this leads to a loss of American jobs. The United States has renegotiated the US-Korea (KORUS) Free Trade Agreement and the North American Free Trade Agreement (NAFTA) with Mexico and Canada, in both cases to the advantage of the United States. In the revised version of the US-Korea Free Trade Agreement, for example, the United States successfully extended the tariff on Korean-made pickup trucks (25%), due to be scrapped on January 1, 2021, until January 1, 2041. Based on the assumption that they meet Korean safety standards so long as they meet US federal safety standards, the revisions also doubled the number of vehicles each auto company can export to Korea, from 25,000 to 50,000 a year. As a condition for removing tariffs on vehicles, the revisions to NAFTA require cars imported from another NAFTA country to contain 75 percent made-in-NAFTA components, up from the current 62.5 percent within three years. The revisions also allow tariffs to be imposed on any vehicles imported from Mexico or Canada after an exemption for the first 2.6 million vehicles a year. Negotiations with the European Union and Japan are still to take place, but it is clear that the United States will seek to revise agreements in its favor by threatening to use protectionist measures, including raised tariffs on automobiles and other means.

This frequent resort to protectionist measures by the United States has brought about a crisis in the free trade system that was constructed under American leadership and drove the rapid growth of the global economy; this system now faces the threat of collapse. However, it is important to remember that protectionism is not limited to the United States; there is a growing tendency toward such measures in other countries as well, though it is not as great as in the US.

### **The background to protectionism: saving jobs, standing up to China**

There are two main factors behind protectionism in the United States. One is an attempt to secure jobs in certain sectors of US industry. Since the election campaign, President Trump has argued that growing imports and direct foreign investment by US firms lead to fewer job opportunities for American workers, and that protectionist measures are necessary to protect jobs by limiting imports and foreign direct investment. Specifically, he has argued that it is necessary to limit imports to be able to protect jobs in heavy industries like steel and automobiles, concentrated in the “rust belt” of the Midwest. He has also espoused protectionism and anti-globalization as a means of criticizing the establishment, made up of the Washington politicians and New York business elites who have pushed the trend toward globalization through the expansion of trade and investment. Workers and other voters who responded to arguments like this from Trump as a candidate played a large role in winning him the presidency; by activating Section 232 of the Trade Expansion Act after taking office, Trump has moved to fulfill his campaign pledges and put them into action.

Another reason for US protectionism is the alarm it feels in the face of China’s rapid development in information technology (IT) and other areas of advanced technology. To achieve the “Chinese dream of the great rejuvenation of the Chinese nation,” China has set a target to become a global economic, military, and cultural superpower alongside the United States by the time of the centenary of the founding of the People’s Republic in 2049. On economic front, it has launched the Made in China 2025 industrial policy with the aim of becoming a manufacturing superpower, and is promoting a strategy built around development of cutting-edge technology. It

is also working on construction of a China-centered economic sphere by implementing the Belt and Road Initiative. The United States sees China's system of state-run capitalism as a challenge to the American-led free trade system, and is seeking to shift the direction of China's policy through protectionist measures, in order to prevent China from achieving policies and strategies that challenge the United States. Specifically, it is demanding an end to intellectual property infringements by Chinese companies, forced technology transfers from foreign companies investing in China, and other unfair practices.

### **The impact of protectionism: economic downturn**

The impact of the trade war between the United States and China is already being felt in a reduction in trade volume, increasing import prices and domestic prices within the importing country on which tariffs were imposed, and falling export prices in the exporting country. We can expect a drop-off in production and consumption in response to these changes in price. At present, the US economy is doing well, as President Trump's policies of tax cuts, increased government spending, and deregulation have their effects, and this is having a positive effect in other economies. However, the impact of these stimulus policies is expected to wane from the beginning of 2019. If the negative economic aspects of protectionism come to the surface in such circumstances, this would likely have serious repercussions not only on the two countries directly involved but on the entire global economy. Today, when countries around the world are closely linked by trade and investment and the global value chain, the negative economic effects of protectionism would be felt throughout the world. Analysis by the International Monetary Fund suggests that a trade war between the United States and China could depress economic growth rates for 2019 by up to 0.9 percent for the United States and China and by up to 0.7 percent for the global economy as a whole.

Will the United States attain its desired objectives through its protectionist measures, canceling out bilateral trade imbalances, reviving the protected industries and saving jobs, and putting an end to China's unfair practices? It seems unlikely. Although tariffs might help to improve bilateral trade figures, it is likely to lead to a trade deficit with other countries, and will therefore not help to increase employment in the United States. On the relationship between trade and employment, the consensus view in economics is what is important is not simply the bilateral trade balance with particular trading partners but the balance of trade with the world as a whole. Protectionist policies are not an effective way of improving the trade balance with the world, and macroeconomic measures relating to exchange rates, fiscal and monetary policies are necessary. Experience teaches that revitalizing industry and saving jobs by protectionist measures is extremely difficult.

The US steel industry was the source of trade frictions with Japan and other countries from the 1970s to the 1990s, owing to an increase in imports. The United States responded by demanding voluntary export restraints and introducing the trigger price mechanism (introduced in 1978 to guarantee a minimum price for imported steel goods with the aim of preventing a sharp increase in steel imports), and has used these measures to protect its steel and related industries with the aim revitalizing these industries. These hopes have not been met and now the administration has resorted to tariffs. But to revitalize an industry that has lost competitiveness, what is needed is not protectionism but a free market environment unbound by red tape that will facilitate improvement of workers' skills and the introduction of new technology.

Protectionist measures that impose additional tariffs on materials like steel and aluminum can be particularly harmful. It is necessary to recognize that tariffs raise prices, which has a knock-on effect on the price of automobiles and other products made from these raw materials. Consumers are not the only ones to suffer as a result. The impact on companies can be severe, as exports become less competitive and sales and production volumes fall. Tariffs end up causing industrial

stagnation and decline—precisely the opposite effects from those they were intended to have. In order to address China’s unfair practices, it would be more effective for the United States to act in partnership with the EU and Japan, which face similar problems.

### **How to maintain the free trade system: mega-FTAs and reforms of the WTO**

By unilaterally imposing protectionist measures against China, which is the second largest economy in the world, the United States, the largest economy, has brought about a trade war between the two countries. This threatens the survival of the global free trade system and is having a serious impact on the entire global economy. Since the use of protectionist measures to protect jobs reflects the personal views of President Trump, it is possible that these policies will be abandoned when his time in office comes to an end. But Trump is not the only influential figure in the United States who is concerned at China’s rise. This sense of alarm is shared by many members of the US Congress and business leaders, and this makes it possible that measures against China may continue long beyond the Trump presidency. What steps can the rest of the world take in these circumstances to persuade the United States to return to a rule-based free trade system? I believe that at least three options are possible, as outlined below.

The first does not require any new policies to be taken but rather involves a possible U-turn in US policy brought about by the increasing severity of the negative impact of protectionist measures on the US economy. If protectionist trade policies are applied in the long term, this will seriously affect the US economy through increasing prices of imported goods and decreasing exports and production. If the outlook becomes bleak, the effect of the economic downturn will be amplified through a fall in stock prices. If the negative impact of protectionist measures makes itself felt in this way, then President Trump may decide to withdraw some of the measures. But the economic circumstances would have to be quite serious to persuade President Trump to shift his policy, and in this case the global economy would also suffer serious damage. This makes this scenario the worst-case scenario of the three possibilities.

The second approach, which has some aspects in common with the first, would be for the world’s major economies—Japan, the EU, China, and so on—to work toward comprehensive and liberal regional integration without the United States on trade and investment, and thus push the United States into a disadvantageous position. If the US business elite truly felt that they were suffering a discriminatory and unfavorable position by being excluded, it is likely that they would demand President Trump to negotiate a place at the table for the United States. This might be attained by ensuring that the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), signed by the remaining 11 countries after the United States quit the original TPP agreement, becomes fully implemented quickly and attracts new members. Similarly, efforts should be made to broaden the membership of the recently enacted economic partnership agreement between Japan and the EU, and to reach agreement and ratification of the Regional Comprehensive Economic Partnership (RCEP), including India and China, as quickly as possible.

The third would be for countries that share interests in common, like Japan and the EU, to involve the United States in efforts to reform the World Trade Organization (WTO), which is responsible for maintaining the present world trade order and is beset by problems. In fact, this movement is already underway, and agreement has been reached at meetings between heads of government and trade ministers from Japan, the US, and the EU on the need for effective enforcement of trade rules and commitments, improvements to the WTO’s monitoring and dispute resolution functions, and the establishment of rules for the increasingly important new field of digital technology. If these efforts progress, it may become possible to curb China’s unfair practices, easing US distrust of China, and possibly leading to a reduction in protectionist measures.