

Who Suffers in a Trade War?



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The U.S. president is shoring up his base at the expense of the international trade order.

When Donald Trump was elected President of the United States, business leaders assured themselves that his nationalist rhetoric was just rhetoric. Wise talking heads trotted out the phrase “Take Trump seriously, but not literally.” They said his threats to revoke NAFTA trigger protectionist measures and renegotiate and abandon trade agreements such as the **TTP** and **KORUS** were all empty threats.

Nearly a year ago, I **warned** that we should take Trump literally and seriously. Most U.S. presidents are acutely sensitive to the needs of their base, because its turnout can mean the difference between winning and losing, so presidents do, in fact, keep most of their promises. One of Trump’s first acts as president was to pull out of the 12-nation trade agreement, the Trans Pacific Partnership (TPP). Was this the strangled squeak of the canary in the coal mine or purely symbolic, since the deal had not been ratified by a divided U.S. Congress? Other evidence continued to accumulate – today, both **NAFTA** and KORUS are being renegotiated. The last chirp, sticking to the poor rapidly dying canary metaphor, is the newly imposed tariffs of 10

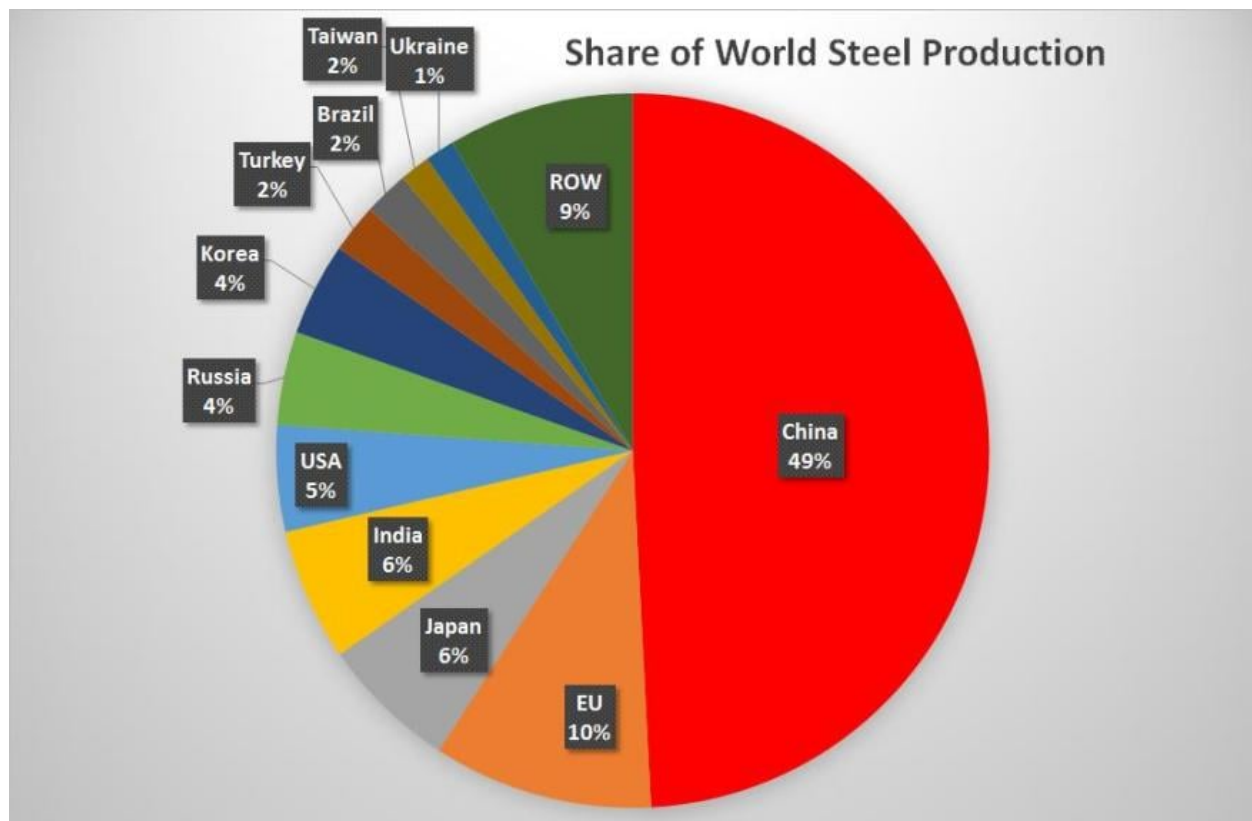
percent on aluminium and 25 percent on steel signed by Trump last week and a **fresh announcement** of US\$60 billion of tariffs on a range of products exported from China.

Real steel

Over the last 60 years, the U.S. steel industry has suffered a steady decline, becoming less competitive and far less central to the U.S. economy. In the years after World War II, American steel mills employed nearly 700,000 workers. Today only 83,000 still work in the nation's steel mills. While some of the decline has been due to import competition, as in many industries, technological changes are an equally important driver of this decline.

At the same time, there is broad consensus that there is a global glut in steel. The source is China. Today, China is the world's top steel producer, accounting for 831.73 million tons of crude steel last year, nearly 50 percent of world production (see Figure 1). Steel capacity in China has increased even more rapidly than production, with capacity nearly tripling in the last decade. Global steel capacity increased by 1,017 million tons over the past decade, 78 percent of which (794 million tons) originated in China.

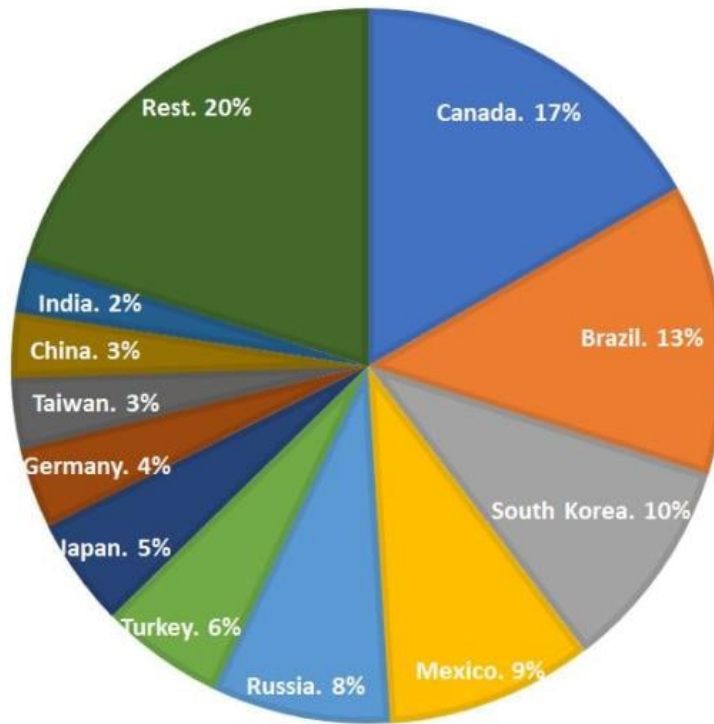
Figure 1



The excess capacity from China has put downward pressure on steel factories and steel workers and this was the *raison d'être* of the Trump tariffs. But, as Figure 2 shows, most U.S. steel imports are from Canada, Brazil, South Korea and Mexico, rather than China. Instead of hitting the source of the global glut in steel – China – the tariffs will hit the closest allies and partners of the U.S., making it far more difficult for them to band together and put pressure on China to ease the global glut.

Figure 2

SHARE OF US STEEL IMPORTS



Shortly after the tariffs were announced, the administration seems to have realised that the tariffs threatened the allies of the U.S., and not China. Canada and Mexico are exempted from the tariff, but this is only to use the threat of tariffs as a bargaining chip in the ongoing NAFTA renegotiations. Temporary exemptions for the European Union, Australia, Argentina, Brazil and South Korea quickly followed, but again, I expect that the temporary nature of the exemptions will be used to pressure these countries in trade negotiations. After a splashy announcement, there was furious lobbying by other countries, eventual backpedalling by the administration, and resignation of Gary Cohn, Trump's chief economic advisor. So, what explains this puzzling sequence of events?

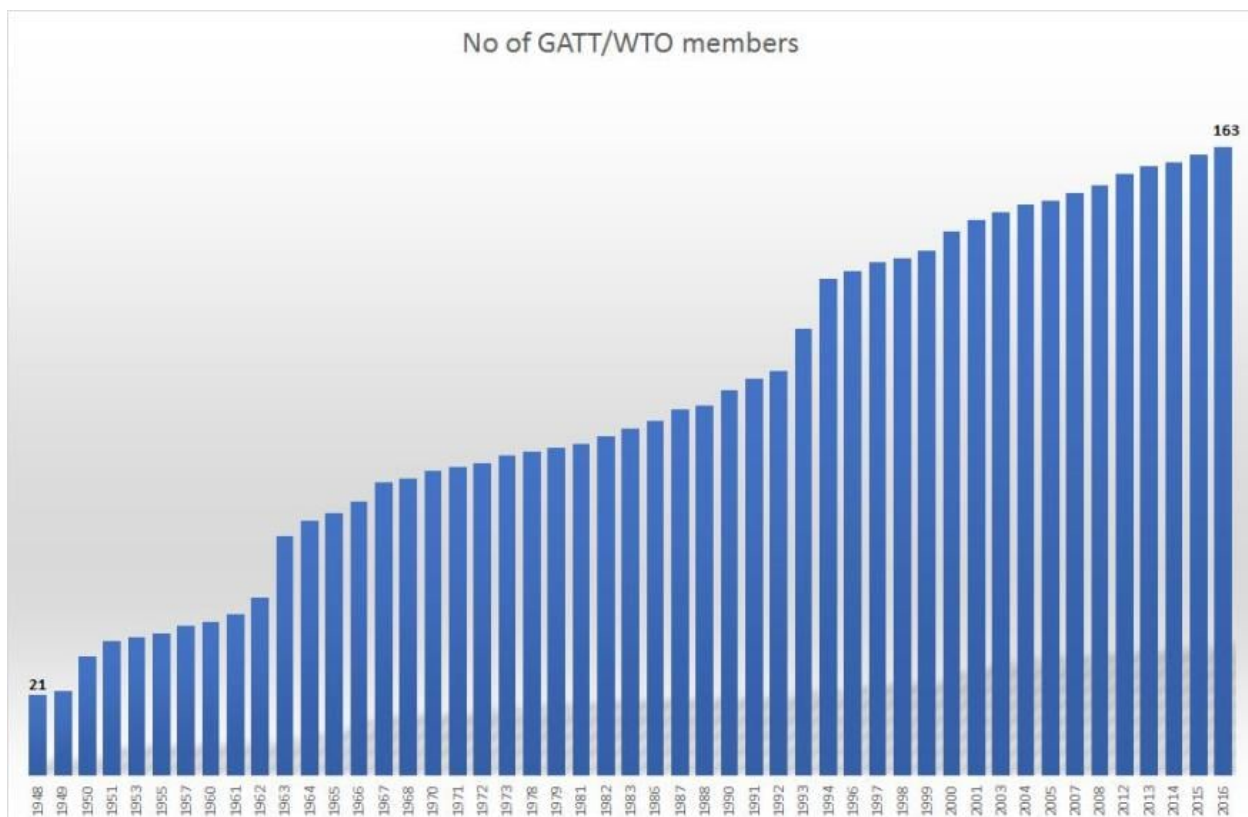
The answer is that Trump tariffs are a purely political gambit to shore up his base and alleviate the risks of a big midterm electoral debacle for the Republican Party. The tariff is unlikely to help the prospects of steel workers in Indiana, Ohio and Pennsylvania in the short- to medium-term. But Trump has signalled that he cares for the American workers, he has kept his populist promise, against the opinions of the elite.

He is gambling that this could be enough to energise his base and stem losses in the midterms. A major loss by the Republicans in November poses an existential threat to Trump given that a Democratic win could trigger investigations into his family, his businesses, supercharge U.S. Special Counsel Robert Mueller's investigation and potentially lead to impeachment.

Why worry?

In short, trade wars. The world has not seen a full-fledged trade war since the Great Depression. The trauma of it was sufficient to lead to the creation of the General Agreement on Tariffs and Trade (GATT), which eventually morphed into the World Trade Organisation (WTO). Starting with 21 founding members in 1948, today nearly every country is either a WTO member or in line for membership (Figure 3).

Figure 3



The underlying principle of the WTO is that if one country extends low tariffs to any WTO member, it must do so to every WTO member. Countries lower trade barriers over rounds of trade talks. In some exceptional cases,

members can impose tariffs (e.g. to counter “dumping”, when a country is selling goods in foreign markets below “reasonable” costs). Invocation of national security is another loophole and the one invoked by Trump. The national security card exception has been rarely used since it can open up a Pandora’s box of retaliatory tariffs under the guise of national security. Nothing stops a country from invoking food security and putting even higher tariffs on agricultural products. This would be devastating for many emerging economies that primarily export food.

The EU threatened retaliatory tariffs of its own against the U.S. on a wide range of products. Its initial list of products for retaliatory action included bourbon, Harley Davidson motorcycles and oranges. Bourbon is from Kentucky, the home of Senate Majority Leader Mitch McConnell; Harley Davidsons are manufactured in Wisconsin, the state of Paul Ryan, the Speaker of the House of Representatives; and oranges are from Florida, the perennial swing state in U.S. politics. Very quickly, exemptions were granted to the EU. Other countries watching will be tempted to retaliate against Boeing aircraft, or agricultural products like beef, pork, wheat or soybeans.

With the latest announcement of a package of US\$60 billion in annual tariffs on Chinese products, we seem to be on the cusp of a global trade war. China has vowed to stand up for itself and is contemplating tariffs ranging between 15 percent and 25 percent on 128 American products. Markets shuddered as the S&P 500 index fell by 2.5 percent on March 22nd and Boeing’s stock declined by more than 5 percent. Global markets, especially in Asia, stumbled as well. Best capturing the uncertainty was a jump of 30 percent in the VIX volatility index.

Such a series of tit-for-tat tariffs can easily escalate into a full-fledged trade war with adverse consequences for the global economy, especially the exporting powerhouses in Asia. Of course, such disputes will be adjudicated at the WTO. The WTO dispute settlement mechanism can legally find that the national security rationale is baseless and permit any country to retaliate with its own protectionist measures that compensate it for its export losses. The thing that worries trade economists the most is how Trump and his advisors will respond to any WTO settlement. Knowing Trump, he could simply ignore the WTO ruling and this would put the entire international trade architecture under risk. The world would be in uncharted territory with severe consequences for global trade and for global supply chains that would

affect all of us, as firms and as consumers. While some may discount such a gloom and doom scenario, we must keep in mind that this is Donald Trump, the destroyer of norms. Trade wars are not easy to win! We will be in the land of unknown unknowns.

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