



# TURNING THE TABLES ON WORLD TRADE?

## REFLECTIONS ON US AND EU TRADE POLICY AFTER THE 2016 AMERICAN PRESIDENTIAL ELECTION

POLICY BRIEF 2018:4

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### BACKGROUND<sup>1</sup>

Donald Trump has both before and after his inauguration in 2017 continuously changed his mind and opinions on key political issues. There is however one issue in which he has been consistent for three decades: Trump is convinced that protectionism works and does good for the United States, and that “trade wars are easy to win. Tariffs and other import barriers will bring back prosperity, security and jobs to the United States.

This viewpoint goes not only against established economic theory but even more against tried and tested historical experiences. Since World War II, the US has promoted open, liberal and market-oriented policies through decisive support for the establishment of the World Trade Organization (WTO) and its predecessor GATT. In 1993 the US, Canada and Mexico joined to form the North American Free Trade Agreement (NAFTA). This agreement has helped make North America a single integrated region for commerce, production and investment. During the Obama administration, the US launched an American “pivot to Asia” and negotiated a new free trade agreement between twelve countries in the Asian Pacific (Trans-Pacific Partnership, TPP). At the same time, the US and the EU took the initiative to negotiate a Transatlantic Trade and Investment Partnership (TTIP).

<sup>1</sup> The author is especially thankful for the considerations of and discussions with Per Altenberg, Uri Dadush, Harry Flam, Henrik Horn, Gary Hufbauer, Janerik Larsson, Mats Lundahl, Cecilia Malmström, Pernilla Norlin, Andre Sapir, Ulrika Stuart Hamilton and Maria Åsenius.

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Upon his inauguration, Donald Trump discarded the already completed draft of the TPP agreement and threatened to tear up or radically renegotiate NAFTA. The TTIP negotiations over a new transatlantic agreement have essentially ceased.

Although a liberal and market-oriented mindset have dominated American trade policy since the 1940's, deep political roots of insular and mercantile views can be found long before the 1930's depression and the Second World War.<sup>2</sup> This leads us to the question: Is Donald Trump spearheading a return to the pre World War II days of protectionism and isolationism, or is he just a temporary aberration in an ever-accelerating globalisation?

Below I list seven conclusions of the paper.

### EXECUTIVE SUMMARY

**FIRST**, *the more protectionist development of American trade policy of the last decade seems likely to be a permanent change for the USA, but still only a temporary anomaly in the world economy's movement towards increasing trade due to reduced trade barriers in general, and reduced tariffs in particular. However, removing other types of trade barriers, such as regulations based on health, safety and environmental concerns, is likely to continue to be unacceptable intrusions in countries' sovereignty.*

**SECOND**, *even without the 2016 election of Donald Trump happening, it is possible that there is an underlying, long term trend towards increased protectionism in the US. If so, it probably has gained strength from a rise in resistance against the consequences of globalization for some regions and industries, resulting e.g. in increased inequalities in income and wealth.*

*The lack of effective and sufficiently funded social safety nets for affected individuals, as well as lack of access to new employment via retraining and further education, are often suggested as causes of resistance to globalization. However, the question of whether these explanations are enough remains.*

*When asked about the increasing resistance to globalisation, I always emphasise that globalisation affects individuals differently and that there are big differences in the political response to globalisation between the US and most EU countries. All western countries should not be lumped together when discussing the advantages and disadvantages of globalisation.*

**THIRD**, *one lesson from Trump's time in power is that it seems important to the rest of the world that the US Congress regains its legislative mandate in questions of trade policy. When passing the Trade Expansion Act in 1962, Congress surrendered legislative power to the president as a result of the decision to include Section 232 on "national security" in the bill.<sup>3</sup> At that time, the president was seen as a champion for world trade and in any case more positive to free trade than Congress. Today, in accordance with the US Constitution's doctrine on separation of powers, the president's ability to act*

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<sup>2</sup> Irwin, D (2017), Clashing Over Commerce. A History of US Trade policy, National Bureau of Economic Research, and U of Chicago Press.

<sup>3</sup> For a basic explanation of Section 232 in the Trade Expansion Act, see <https://www.investopedia.com/terms/s/section-232-trade-expansion-act.asp>.

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*against import with a simple declaration of “national security” should be limited. Returning the mandate in Section 232 to Congress would in the long term make US trade policy more predictable and perhaps also more free trade oriented. Today, the American constitution together with the set of laws and regulations combine into a collective bias against imports and free trade. It is in the interests of the rest of the world to assert its interest in an open and stable American trade policy.*

**FOURTH**, *for the world and the US alike, the Trump administration’s uniquely frequent utilization of Section 232 has led to a sharp increase in uncertainty over the rules of international trade. To discourage a Trump-inspired protectionism from spreading among WTO members, it is therefore paramount that key WTO members – such as the EU, Japan, China, Australia, Mexico, Argentina and Brazil – unite and form an international ‘pact’ to safeguard the rules of the multilateral trading system as we know it. However, for such a pact to come about and to function, it would probably be necessary to change some of the existing WTO rules, and reform the Chinese trade policy. China would have to accept the WTO rules forbidding the subsidies and economic support that Chinese producers enjoy today.*

**FIFTH**, *if protectionism becomes established practice in the US, there is substantial risk that it will spread to many developing countries lacking experience with export-led growth, free trade and economic liberalism. The poor countries of the world could remain more impoverished.*

**SIXTH**, *for the European Union, fundamental questions about global leadership have now arisen and demand action. The EU should henceforth pursue trade, defence and military policies more independently of the US. This would entail increasing public spending on these policy areas, primarily on defence.*

*This also entails a broader role for the EU globally. The EU cannot fill the vacuum left by the US if it acts in accordance to an “EU-first” maxim. Global leadership requires a desire to work for broader principles – such as multilateralism – as well as a preparedness to handle costs and political strains in times of disputes and conflict. It is not enough for the EU and other key WTO members to just focus on being exempt from protectionist policies for themselves only, like exemptions from Trump’s aggressive trade policy in steel.*

**FINALLY**, *there is a need for a stronger global leadership when it comes to general liberal stances on market economy, free trade and rule of law. Foreign and trade policy should not only be guided by self-interest, but also by ideas and principles.*

## TRADE POLICY TENDS TO BE LINKED WITH SECURITY POLICY AND DEFENCE POLICY

Economists tend to limit their analyses of international trade to economic aspects such as the effects on GDP growth, relative prices, the income distribution, trade patterns, global poverty, and the spread of knowledge and technology. These analyses do not usually address the connections between trade policy and countries’ interest in international influence.

The standard procedure in post-war international politics has been for the key negotiating countries such as the US, the EU, Japan and China to isolate economic negotiations from military and defence matters, despite that rigorous strategic decision-making includes both.

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With Donald Trump, things are different. He does not hesitate in his desire to exploit the influence of the US to win perceived economic advantages, or to use trade policy as a method for getting other countries to follow the desires of the American government.

A recent and potentially important example is a provision in the renegotiated NAFTA agreement, now named the US-Mexico-Canada Agreement (USMCA). The provision requires Canada or Mexico to notify the US at least three months in advance if either intends to enter trade talks with a “non-market economy”. This means above all China. If such a deal is being made, the US could pull out of the USMCA. The US may suggest similar provisions that would undermine a sovereign trade policy in future agreements with e.g. EU and Japan.<sup>4</sup>

To be sure, mixing trade and foreign policy is nothing new, but Trump appears to have the self-interest of the US as his foremost and only motivator and is clearly doubtful about taking a global responsibility for trade, commerce and peace.

### DEFICIT – SO WHAT?

There are frequent complaints from the Trump administration that the US has merchandise trade deficits with numerous countries, and that these deficits indicate that the US is losing out on trading with each one of these countries.

To start, one can wonder why trade in services are not included. Trade in services is certainly growing faster than merchandise trade,<sup>5</sup> and can in value terms be just as important, if not more important, when measuring in value-added terms.<sup>6</sup> But is it true that a trade deficit with a country indicates that the country – in this case the US – is losing out on trading with the other country?

Having a trade deficit does not imply reduced welfare or fewer jobs. If two countries trade with one another, it is because both countries think that they benefit from doing so.<sup>7</sup> If not, the country seen to lose out on trade would not engage in the exchange, and this is true for all kinds of transactions. To engage in trade is voluntary, and either party involved can refrain if desired.

When you go to a bakery and buy bread, the baker is pleased with the transaction if the earnings cover the costs. You are pleased to eat the bread if the bread meets your expectations. Both parties are satisfied when it is a voluntary trade.

So, the Trump administration’s presumption that the US is losing out on trade is either incorrect or assumes that at least one trading party is being forced into the trade. The United States does not have to trade with China, or the EU, or anyone else.<sup>8</sup>

4 “Trump tries to cut China out of trade deals with partners”, Financial Times, October 7, 2018.

5 Per Altenberg has kindly helped me with this classic and statistically difficult to measure question on the scope of merchandise trade and trade in services. The simplest way is to compare the gross trades; see [https://www.wto.org/english/res\\_e/statis\\_e/wts2017\\_e/wts2017\\_e.pdf](https://www.wto.org/english/res_e/statis_e/wts2017_e/wts2017_e.pdf), page 10.

6 You can also analyse trade in services from a value-added perspective, i.e. based on input-output calculations. In Sweden, for instance, services were estimated to make up 61 % of Sweden’s gross exports in 2014, according to OECD’s TiVA database. This percentage has been rising for some time in Sweden. Other OECD countries have a similar level to Sweden, see “total services value-added as share of gross exports”: [https://stats.oecd.org/Index.aspx?DataSetCode=TIVA\\_NOWCAST](https://stats.oecd.org/Index.aspx?DataSetCode=TIVA_NOWCAST). Email from Per Altenberg, Kommerskollegium, 22/8 2018.

7 In most cases the benefits are equal for both parties, but there are exceptions which are discussed in theoretical literature.

8 The only example I can think of would be the war reparations Finland was forced to pay to the Soviet Union in the form of Finnish exported goods after World War II.

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## TRADE OCCURS BETWEEN FIRMS, NOT COUNTRIES

Furthermore, it is neither the countries nor their governments that trade with one another, although it may sometimes seem so in the simplified world of trade theory. In most cases, trade occurs between profit-maximizing firms convinced that they have something to gain from trade.

On this point there is an inconsistency in the Trump administration's views. In a market economy, trade barriers constitute serious state interventions. Even though both the Trump administration and the Republican Party see themselves as supporting an economy free from state interference and built on the principles of market economy, the administration's trade policy is driven by goals and values that fundamentally differ from those of the market. It is contradictory to aim at reducing regulations in general while simultaneously increasing state interference in foreign trade. One could expect that the Trump administration would see state interventions in foreign trade as a political overstep and an encroachment on the freedom of individuals, consumers and firms. This aspect of trade policy seems however to be a blind spot for today's US republicans, and traditionally also for the democrats.

## TRADE POLICIES ARE NOT DICTATED BY ONLY ONE COUNTRY

Trade policy in one country usually affects policies of other countries; there are spill over effects. It is therefore common in politics to consider reactions and effects in other countries when analysing the consequences of trade policy *ex ante*. Are retaliation and backlashes triggered? Are new alliances formed? Are trade flows changed? Is the international allocation of production affected? The Trump administration have hardly been seen to have initiated such thought processes, despite for example the fact that reciprocity is a key principle in trade policy.

One recent example of such a spill over effect is when the US steeply raised tariffs on an array of imported Chinese goods in June 2018. In retaliation, China immediately introduced a 25 % tariff on the import of, among other things, soybeans from the US.<sup>9</sup> The Chinese retaliations reduced the profitability for farmers and exporters – primarily in Illinois, Iowa and Minnesota – by lowering the price of soybeans (China replaced soybeans from the US with increased import of soybeans from Brazil). The fact that China chose to have the bulk of their countermeasures affecting these three states is no coincidence since the election results from these states are likely to be crucial for the Republicans in future general elections.<sup>10</sup>

As a reaction, president Trump promptly promised a support package of twelve billion USD to the affected soybean farmers and other affected groups.

To sum up: The increased American trade barriers against China resulted in increasing subsidies to farmers in the US, lower prices for American soybean producers, the risk of Brazilian producers in the long run taking a portion of the Chinese market from American farmers, and a distorted competition in several markets.<sup>11</sup>

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<sup>9</sup> Soybeans are grown e.g. in the American Midwest and in Latin America, and are used as compound feed for pigs, for example

<sup>10</sup> Trump has stated that he regards the pattern of Chinese retaliation as a political interference in the US midterm elections in 2018.

<sup>11</sup> Presidents Richard Nixon and Jimmy Carter have also made interventions resulting in negative consequences for American farmers and agricultural exports. Nixon's restrictions on the export of soybeans to Japan led to the Japanese agriculture becoming more self-sufficient, to the long-term detriment of American agricultural export to Japan. Carter interfered with wheat export to Russia during the Soviet-Afghan War; in doing so, he turned the farmers against him and helped Ronald Reagan, who promised the farmers, "never again".

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Later, Donald Trump claimed publicly that the EU had agreed to purchase “lots of” American soybeans. This was promptly dismissed by ministers from Germany and France, among others. No one from the EU acknowledged any obligation concerning increasing EU import of American soybeans and, apart from a small obligatory mention, there are no statements from the negotiations mentioning soybeans.<sup>12</sup> It is also difficult to determine what the EU even *could* do, as the EU’s tariffs on soybeans is already at zero percent, and that the alleged promise to Trump of large purchases of soybeans would need to have been suggested by the EU Commission, and have been supported by the member states and the European Parliament. It is also unclear to whom any instruction to purchase American soybeans could be made.<sup>13</sup> The EU is no command economy, and those who trade in for example soybeans are individual companies – not member states, and certainly not the EU Commission.

Thus, Donald Trump spoke untruthfully, as he so often does. What is more, his offer of US state subsidies was rejected not only by the American soybean farmers themselves – perhaps having learned from earlier experiences with government intervention – but even by portions of Trump’s own party: “Agricultural groups found [Trump’s aid programme] insulting and inefficient, [and some] free market Republicans likened it to a Soviet scheme.”<sup>14</sup>

### CONSIDER LAWS AND CONSTITUTIONAL RULES ON FOREIGN TRADE

The soybean incident illustrates, among other things, a lack of interest into the legal and constitutional aspects when it comes to trade policy. Financial markets and media are frequently overlooking that there are stipulations on who can make decisions about trade policy, and how those decisions should be shaped.

On both sides of the Atlantic there are potential and ongoing constitutional battles between the executive branch (the EU Commission, the US president), and the legislative branch (Congress and the states, and the European Parliament and EU member states). In the US case, the question arises what the states are allowed to do regarding WTO rules about public procurement, regulations on state level concerning the protection of health, safety and the environment, and licencing of domestic and foreign insurance companies.<sup>15</sup> In the EU, the national parliaments can have regulatory and legislative power in questions that might affect foreign trade. Additionally, there are federal (in the case of US) and supranational (in the case of EU) parliamentary levels playing its role in the mentioned constitutional battles – the European Parliament and the US Congress.

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<sup>12</sup> EU Commission statement 18/4687, “Joint US-EU Statement following President Juncker’s visit to the White House”, 25/7 2018, Reuters 28/7 2018, Financial Times 26/7 and 31/7 2018. Chair of the Committee on International Trade Bernd Lange has written an ample and critical commentary to the Juncker-Trump meeting in July 2018; see <http://www.bernd-lange.de/aktuell/nachrichten/2018/374053.php>, which is also an inventory of the current disagreements on trade policy between the EU and the US, including agricultural products.

<sup>13</sup> Trump’s promise in 2018 of government subsidies to soybean farmers is not required to be approved by Congress as a budgetary issue, nor as a trade and finance policy question. The money could be taken from a slush fund, or contingency fund, which has been previously used.

<sup>14</sup> Financial Times 31/7 2018.

<sup>15</sup> Email correspondence with Gary Hufbauer 10/7 2018.

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### THE WINDING ROADS OF CAR TRADE

The soybeans case highlights that trade barriers can lead to unforeseen effects in a world of strong interdependences. Another example is the US's threat to raise tariffs on imported cars from the EU. Mercedes and BMW had originally planned to in 2018 produce 154,000 cars in their facilities in the US and then export the cars to China.<sup>16</sup> A decision on higher American car tariffs would however change the initial conditions. Most likely, the German cars produced in American factories would be redirected from China to the American market. The Chinese demand for Mercedes and BMW cars would instead be met by increasing production in the EU. The outcome would thus be: Lost opportunities of job creation at the facilities in the US, an increase in the US's trade deficit with China, and an expansion of jobs and production in the EU car industry. That could hardly have been president Trump's intention.

### THE SEPARATION OF POWERS IN THE US: HOW DOES CONGRESS'S CONTROL OF THE PRESIDENT'S EXECUTIVE POWER WORK IN TRADE POLICY?

The legal foundation for the implementation of the Trump administration's tariffs on steel and aluminium in 2018 is found in Section 232 of the Trade Expansion Act (1962).<sup>17</sup> The notion that the national security of the US would be threatened by steel import from Canada, for example, lacks credibility. The argument is nonsense, which has been asserted many times by, among others, the US Department of Defence. This is particularly the case regarding import from close allies of the US such as Canada, Japan and most EU nations.

China's steel export to the US has in recent years been reduced to an insignificant amount or reaches the US by way of being processed in other countries, who then are registered as exporting country.<sup>18</sup>

Nevertheless, Trump has received support in America for his actions against Canada and the EU. Perhaps most surprising are the lame protests from legislators in the American Congress against Trump's *de facto* change of the US's long-established trade policy. The elected law makers do not appear keen on protecting their constitutional right of legislative power over trade policy. One would otherwise have expected Congress to remove Section 232 after the end of the cold war in order to maintain the country's famous system of separation of powers and checks and balances.<sup>19</sup>

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16 Financial Times 22/5 2018.

17 Hufbauer, G (2016), "Could a President Trump Shackle Imports?", Brief, Institute for international Economics, Washington DC. For more information on "Section 232", see Bailos, J. (1990), Oil imports and national security: the legal framework and policy framework for ensuring the United States access to strategic resources', University of Pennsylvania Journal of International Law, Vol. 11, Iss. 2 [2014], Art. 2.

18 The following may be of interest for steel enthusiasts as an explanation for the worry of e.g. Swedish steel producers over trade deflection of Chinese steel to the EU: "In February [of 2018] the [US] Department of Commerce released its Section 232 investigation, in which it determined that imported steel was a national security risk. [T]he reports provides some insight into how the global steel industry works. Here's testimony in the investigation from Tom Gibson of the American Iron and Steel Institute (admittedly not an impartial observer): "But while direct steel imports from China may be down, the high level of Chinese exports to the world continue to put pressure on the global steel market, and leads to increased imports from many third countries. Chinese exports to third countries are being further processed into downstream steel products that are then exported to the United States. For example, Chinese billets are being further processed in Turkey into long products which are then exported to the United States, while Chinese flat-rolled steel is being converted into pipe products in Korea which are then, according to Commerce Department determinations, being dumped into the U.S. market. In addition, Chinese cold-rolled and corrosion-resistant steel is being shipped to Vietnam for minor further processing before being exported to the United States is a blatant effort to circumvent AD [anti-dumping] and CVD [counter vailing duties] orders on these products. As a result, the U.S. industry continues to suffer from the injurious impact of Chinese overproduction of steel that is exported to world markets." (Financial Times 15/8 2018).

19 The separation of powers model dictates, among other things, that only Congress can make laws, and sets limitations on the executive power's – the president's – ability to singlehandedly create something that could be perceived as a new law.

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Accordingly, it will be interesting and important – not least for the rest of the world – to follow the lawsuit filed in July 2018 by an array of representatives of the American business sector against the US government (the Trump administration) for imposing tariffs on steel.<sup>20</sup> The plaintiffs are seeking a court declaration that the way in which Section 232 is being utilized violates Article 1 of the US Constitution stating that it is Congress – not the president! – that has legislative power to “lay and collect taxes, duties, imposts and excises”, and that Congress cannot delegate any of these duties without an “intelligible principle” – as defined according to a 1928 precedent. The intelligible principle would be that “import is a threat to national security”. What places even more power in the hands of the president is that Section 232 allows the president “unfettered discretion” to decide how and which measures will be taken (tariffs, quotas, etc), to what extent, applied to which goods, against which countries, and the time frame for those measures. In short, Section 232 gives the president unlimited discretion, which according to the plaintiffs in the lawsuit against the US government violates the separation of powers outlined in the constitution.

The case is centred on the 25 % tariff on steel import from most, though not all, countries. The suit also highlights Department of Commerce’s hearing of cases for individual exemptions from the 25 % tariff. 37 witnesses testified about the consequences during a public hearing at the Department of Commerce in May 2017 in conjunction with the decision to introduce the tariffs. An additional 200 written statements were submitted.

It is interesting to note that the provisions in Section 232 do not require that the president considers these testimonies and petitions in cases where national security is claimed to be affected by import. Nor does Section 232 prevent the president from – if he wishes – to consider the petitions, or to only consider certain statements and disregard other. Most importantly, Section 232 does not instruct the president if or how to act. In other words, the president can choose to ignore the petitions entirely, and does not need to take any measures at all. The president can take any measure, and any measure is possible.

All this causes a far-reaching legal uncertainty which makes it puzzling that Congress has left Section 232 unchanged for decades. What the plaintiffs who sued the US government for violating the constitution are focusing on is precisely this, the de facto ability of the president to singlehandedly exercise legislative powers.

The Trump administration’s new interpretation and application of Section 232 in the Trade Expansion Act opens an entirely new uncertainty in international trade. To prevent a Trump-inspired protectionism from spreading, it is therefore important that other WTO members preserve the multilateral trade system as it was intended.

The EU and other WTO member countries have filed numerous complaints to the WTO about Trump’s aggressive trade policy. The WTO will likely judge in the complainants’ favour, meaning that they would win the right to compensation from the US and to implement countermeasures. But such a process takes time and could negatively affect member states’ willingness to abide by the WTO’s rules and dispute settlements.

Essentially, the treatment of the 2018 actions of the US should be a question for the member states rather than for the WTO’s dispute settlement procedures. The provocative actions of the US as a world superpower may lead to the legal framework of the WTO ceasing to fully function rather than to correct US trade policy. The US’s free trade agreements currently have an uncertain legal status, considering how the Trump administration at any time (according to Section 232) can override a trade agreement.

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<sup>20</sup> Section 232 of the Trade Expansion Act, 1962. Case number: Case 1:18-cv-00152-N/A Document 20 Filed 07/19/18

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## DON'T BLAME POOR COMPETITIVENESS ON FREE TRADE

When a country has weak demand for its exporting products on the world market, it is because its producers are uncompetitive. And why are they not competitive? This is the type of questions an analysis on trade policy usually begins with, rather than speculations about “unfair trade agreements”.

Poor competitiveness can have several explanations: long-term structural problems such as an unskilled workforce, low quality schools and universities, substandard logistical infrastructure, complicated and corrupt legal and taxation systems, or political oppression and instability. Another issue could be high production costs, which can be due to a combination of an overvalued currency, weak productivity growth, poor rate of innovation, and rapid cost increases, e.g. wages and salaries.

A depreciating currency implies more expensive imports and cheaper exports, and thus the country's producers become more competitive. Furthermore, a depreciation can result in lower nominal wages, and thus likely lower real wages in the short run which spurs competitiveness. However, in the long run the increase of import prices can cause a wage-price spiral which could reverse the initial improvement in competitiveness. Then, other forms of growth enhancing policy is needed, such as a combination of cost-cutting measures and structural reforms. The source of a country's lack of international competitiveness is, however, seldom (or never) attributed to “unfair trade agreements” – and this also applies for the US.

What, then, is the cause of the present US's foreign trade deficit? The reason is that US-based households and firms spend more than they earn and finance the difference through borrowing abroad, largely from Chinese savers. In the absence of e.g. a reliable pension system in China, a high Chinese savings rate is sensible. How long this high savings rate will remain depends on several factors, like demography.

Because the cause of the US's deficit is linked to the difference between consumption and production in America, the adequate measures for reducing the deficit should be aimed at increasing the savings of individuals and firms in the US, as well as the American government's and public sector's savings. The deficit will be reduced only if the American consumers and America-based firms save more and consume less. Consequently, imports will decrease, and less foreign savings will be required to finance the lower American consumption. Such a change could for example be attained by raising US taxes.

The tax cut of the Trump administration in 2018, on the other hand, increases consumption and, accordingly, the foreign trade deficit. So, Trump's tax cuts go against Trump's objective about lowering the trade deficit. Yes, it is illogical.

What we can observe since the 2016 election in the US is that the Republican Party has not only moved away from being the free trade promoting party as we know it – primarily since president Ronald Reagan's administration 1981–1989 – but also away from being a fiscally frugal party to exacerbating the public sector's budget deficit and increasing its borrowing. This brings me to an issue I often encounter when discussing the economic relations between the US and China.

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## CHINA – A HOSTILE NON-MARKET ECONOMY

A fundamental complication in US's relation with China is that the US needs China's support against the nuclear threat from North Korea. Specifically, the US needs the Chinese government's support in implementing measures like sanctions and stricter border controls of all goods and services against North Korea. To eliminate this threat is of course also a high priority for China. And yet, paradoxically it seems, the US spent the first half of 2018 starting a trade war against China!

The US's increased tariffs on imports from China triggered an immediate counter-strike and higher tariffs from the Chinese side on import of American goods. The next time that North Korea escalates its conflict with the US, is it certain that China will once again accommodate the US with sharp (or sharpened) sanctions and border controls on trade with North Korea?

The Chinese government is in firm control of the country. The country has a well-run central bank, probably a relatively effective control over the banking system, good control of the public sector's income and expenditures, as well as control over Chinese citizens, firms and banks financial transactions with foreigners. If the Chinese government should wish to reduce domestic Chinese lending to firms and financial institutions in the US, it is well equipped to do so. The price that China and particularly its future pensioners would have to pay for this would be in the form of a lower GDP growth. So far, Chinese investors and pension savers seem to still be willing to continue to invest in the US.

That brings us to the question of the American dollar (USD) as a reserve currency, and the restriction that this attribute places on the US's freedom of action with its currency.

## THE TRADITIONAL VIEW OF THE AMERICAN DOLLAR'S STATUS AS THE WORLD'S RESERVE CURRENCY

The American dollar (USD) is the reserve currency for most the world's economies. This means that the world regards the USD to be the safest store of value, and to always be liquid and exchangeable. That the US dollar is "strong" – that is, has a stable relationship to other major currencies – is considered to lie in the US's best interest, and in the interests of other countries and organizations (such as the International Monetary Fund, IMF, in its role as watchdog for international stability). They would likely want to avoid a situation with for example reoccurring competitive devaluations between countries.<sup>21</sup>

If interested in weakening the USD, the American government or Federal Reserve Bank could sell dollars from its holdings and purchase other currencies. The US can also encourage other countries to hold more of currencies other than US dollar – for instance the euro or the Chinese renminbi – as stores of value and reserve currencies.

A weaker dollar – i.e. a depreciation of the dollar -- could be positive for the American economy's short run competitiveness. However, it would at the same time entail the US giving up the ambition of having its currency as the benchmark of the world economy. In addition, it would mean less influence for the US in international markets, higher overseas borrowing costs (because the currency's future value is more uncertain), and a reduced seigniorage<sup>22</sup> for the US Federal Reserve Bank.

21 During Richard Nixon's presidency in 1971, the US dollar's value was depreciated during a dramatic currency crisis; see Irwin (2017), "The Nixon Shock", p. 542.

22 Seigniorage is a central bank's income from borrowing free of interest from those who hold its currency.

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## THE US'S UNWILLINGNESS TO YIELD TO INTERNATIONAL COURTS AND RULES

The US has always been torn in the matter of having to bow and follow international rules that they themselves have helped create and form. The rules should apply to others, but preferably not the US, it seems. The willingness of the US to follow WTO rules is important – if not crucial – for the credibility of the organization, and for the WTO to be able to function as a guide for other countries.

But with the Trump administration, the willingness of the US to take responsibility for the rest of the world has weakened. Trump has even threatened that the US could leave the WTO dispute settlement system. The same ambivalent attitude towards commitment can be found in the US's bilateral and regional trade agreements. The possibility to utilize the new interpretation of Section 232, as outlined above, seems to always be available for Trump's America nowadays.

This somewhat arrogant attitude towards WTO may have deceived the Trump administration to miscalculate how prepared and determined – and in accordance with WTO rules! – EU, Japan, China and others were to impose countermeasures when US put its steel and aluminium tariffs in place in the summer of 2018 on the grounds of “national security”.

A similar miscalculation of an opponent's determination occurred in the EU-US conflict regarding US imports of cars from the EU. Early in the summer of 2018, the US government argued that the EU should accept an agreement in which they voluntarily would restrict their car export to the US. The euphemistic phrase for this is “voluntary export restraints” (VER). The US's suggestion of VERs goes against WTO rules, has previously been abolished in other product areas (textiles and clothing for example), and conflicts with consumer interests, fair competition, free trade and a market economy.

With a “voluntary export restraint”, it would no longer be consumer demand in the US that would determine which cars would be imported and sold in the US, which prices would be set, or future decisions on supply and demand. Instead, it would be bureaucrats in state trade agencies – most likely working under the influence of the car industry – who would determine the size of import quotas for new cars, what brands and types of cars that would be prioritized in a quota allocation, for how long the VERs would be in place, the conditions that would need to be met for renewal of VER-quotas, etc. If accepted, the proposals of the American government would mean that the world's two leading market economies – the EU and the US – together would decide how the market for one of the most important goods in world trade – cars – would be cut off from the market mechanism.

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## **INTEGRATING ECONOMIES THROUGH GLOBAL VALUE CHAINS (GVC) RAISES THE COST OF PROTECTIONIST ACTIONS AND ENCOURAGES FREE TRADE**

A relatively new element (of the past 20–30 years) in world trade is “global value chains”, or sometimes “global supply chains”. In today’s globalised world, intermediate goods, components and subparts of finished products are produced and traded across the whole world. The final steps in a production process can be the result of manufacturing and assembling of hundreds of parts and components. This makes production vulnerable to disruptions not only in the production process but also in the logistics needed in order for manufacturing and assembly to arrive at a final product. In other words, successful exports require successful imports.

An obvious reaction to protectionism is that producers could relocate production and assembly work, which would make a chain of production less vulnerable to interruptions and protectionist actions. If a country like the US or the EU implement trade barriers against specific exporting countries, manufacturing and assembly can be relocated to other countries with a lower risk of new trade barriers. Manufacturing currently outside of the EU and the US could then also move back to the EU and the US. Several examples of trade barriers inducing relocation of production have been reported lately from China and Mexico to Cambodia, Vietnam, and Malaysia, among others.<sup>23</sup>

It is possible that the EU’s raised tariffs on imports of heavy motorcycles manufactured in the US, like Harley Davidson – a response to higher US’s steel tariffs – will relocate production from the US to Asia. The result seems to be that the number of Harley Davidson bikes sold in EU being about the same as before but instead made in Asia. The relocation of production to new producing countries because of new protectionism will most likely lead to higher prices for consumers.

Tariffs and other trade barriers are not an effective method for reducing trade deficit or for creating increased prosperity. As many have pointed out, the Trump administration is operating under misconceived notions of the world economy and seems to overestimate the US’s role and power in the world economy.

The new protectionist American trade policy is likely to be a permanent change for the USA, in my view, but possibly just a temporary aberration for the world economy. The emergence of global value chains, new modes of communication, data flows, and logistics make protectionist interventions less effective and more expensive than say, in the 1930’s, or in the diagrams found in classic economics textbooks.

The Trump administration’s “America First” policy has been responded by counter measures and consequently, “America Alone” would be a more accurate label for president Trump’s trade policy. This could constitute the start of a pattern of continuous trade policy disputes between the US and other countries, and could possibly prevent the US from achieving other policy goals in international politics, such as the role of an influential global superpower.

“China bashing” is politically popular in the US. An American crusade against China’s economic size and growing influence is however unlikely to be successful if the US at the same time withdraws from trading with its allies and turns its back on world trade.

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<sup>23</sup> See “US-China trade war prompts rethink on supply chains”, Financial Times, 3 September 2018, Hamilton, C (2016), “Globalisering på reträtt”, Ekonomisk Debatt, 2016:3, and Bigsten, A (2018), “År globaliseringen hållbar?”, Ekonomisk Debatt, 2018:5.

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China has been unprecedentedly successful with increasing the country's prosperity and global influence through export led growth and WTO-membership. China is the country in the world with the most to gain if the free trade policies of the recent decades can continue, if WTO regulations are respected and arbitrariness and political conjectures are not allowed to set the rules of world trade. China, Japan, and other trade-oriented countries in Asia and the European Union all have a strong economic interest in being strong counterweights to protectionism.

One telling example can be found in 2017, when Japan de facto took over the US's role in completing the Trans Pacific Partnership (TPP) after Trump had torn it up. Today a modified version of the agreement is in place, without the US. Furthermore, Japan and the EU concluded a new free trade agreement in 2018, which opens the previously closed Japanese food and agricultural market for imports from the EU. Such an opening has in the past been strongly desired by American food and agricultural producers, but Trump's new trade policy has prevented their entry, to the benefit of the European exporters.

What can be seen thus far is that the EU – and its member countries with strong national social safety-nets – continue to increasingly trade with non- EU-countries such as China, Japan, Korea and other Asian countries, and hopefully countries in Africa and Latin America. It indicates that US trade policies will not, under Trump, change the already established trade-oriented nations' relatively open trade policies, and that the US's protectionism is contained to the US itself. There is however a risk that the US's protectionism could spread to many poor nations.<sup>24</sup>

What worries me is that political institutions in the US, which should uphold the principles of rule of law and democracy, don't seem to cope in a politically increasingly polarized US. Section 232 means that the US follows the Constitution on paper, but that Congress in a specific situation can hand over legislative power to the president in a way that for decades seems to have contradicted the principle of separation of powers.

## CONCLUSIONS FOR THE EU

The EU will be required from now on to manage its trade policies as well as its defence and security policies more independently from the US. This also entails a broader role for the EU globally. The EU cannot fill the vacuum left by the US if it acts in accordance to an "EU-first" maxim. Global leadership requires a desire to work for broader principles – such as multilateralism – as well as a preparedness to handle costs and political strains in times of disputes and conflict. It is not enough for the EU and other key WTO members to just focus on being exempt from protectionist actions for themselves only, like exemptions from Trump's aggressive trade policy in steel.

I would claim that Donald Trump's policies have unified EU countries in their outlook concerning trade policy, and that they are more in agreement now than ever before in the modern history of the EU. Southern Europe has chosen a more open stance towards free trade in response to the US's protectionism. The EU's internal market – with its strong purchasing power and being free of internal trade barriers – is a protective shield, especially for the smaller EU countries, against non-European's trade conflicts and trade wars.<sup>25</sup>

<sup>24</sup> See Bigsten, A (2018), "Är globaliseringen hållbar?", Ekonomisk Debatt, 2018:5.

<sup>25</sup> See interesting viewpoints and policy suggestions concerning the EU's situation in Jean, S., Martin, P., Sapir, A. (2018) "International trade under attack: what strategy for Europe?", Bruegel Policy Contribution, Issue no.12, August.

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The EU is trying to take the lead in the defence of the multilateral trade system and is negotiating free trade agreements and on trade issues with almost the entire world. A proposed suggestion has been to form a “circle of friends” for the WTO and the multilateral trading systems. This pact would then include three cornerstones:

First, cooperation and collaboration with the US and Japan (on a ministerial level). The circle of friends is discussing how one should formulate propositions for a partially new legal framework of the WTO. Focus is on contemporary issues regarding industry subsidies and forced technology transfers, i.e. points where China’s actions cause severe tensions.<sup>26</sup>

Second, the EU has created a task force together with China. The group had its first meeting in the summer of 2018. China has in general expressed a positive attitude and is openly supportive towards the WTO. However, China must also go from words to concrete action.

Third, the EU has put forth several proposals for broader reforms of the WTO. These proposals will be discussed during the fall and winter of 2018–19 with many WTO members in for instance ministerial meetings.

In addition to these concrete initiatives, there is a strong general need for global leadership by the EU when it comes to general liberal values such as democracy, market economy, free trade and the rule of law. Russia and China, for example, have little or nothing to contribute on these matters. Foreign policy and trade should not be guided by economic interests alone, but also by ideals and principles.

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<sup>26</sup> See for example “Trade wars: China fears an emerging united front”, Financial Times, 11/9 2018.

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