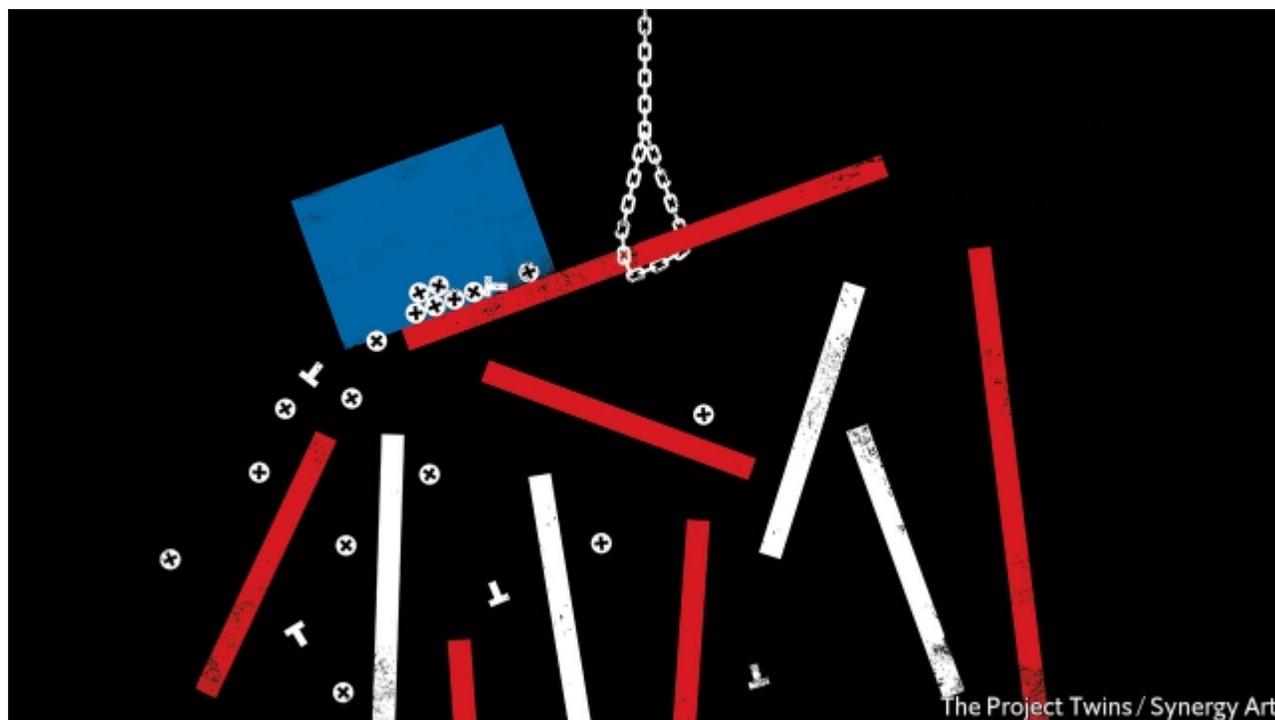


A tariffically bad idea

The looming global trade war

America is setting dangerous new precedents as it tries to curb imports



The Project Twins / Synergy Art

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PRESIDENT Donald Trump does not follow through on everything he says or tweets. Sometimes he blithely ignores past statements, sometimes he seamlessly reverses himself. For a while, hopes that tariffs of 25% on steel imports, and 10% on aluminium, which the president announced on March 1st, might not actually come to pass hung by that thread.

The thread snapped on March 6th when Gary Cohn, an investment banker, resigned from his post as Mr Trump's chief economic adviser. For months Mr Cohn had been fighting Peter Navarro, Mr Trump's trade adviser, and Wilbur Ross, his commerce secretary, over the proposed tariffs. His departure could only mean he had been beaten, and that a formal declaration of the tariffs will follow shortly, quite possibly

soon after *The Economist* went to press on March 8th. The measures, it appears, may not be as sweeping as originally suggested; in particular, Canada and Mexico may be exempt. But they are worrying enough.

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As Mr Trump originally described them, the tariffs would apply to some \$46bn of trade, roughly 2% of America's goods imports. That would make them Mr Trump's biggest act of protectionism to date. But the size of the provocation is not what is most worrying: the way it was done, and the belief that inspired it, both matter more.

Mr Trump's previous trade restrictions, like the tariffs on solar panels and washing machines he announced in January, had precedent. They were part of a recognised process, the sort of thing the World Trade Organisation (WTO) deals with routinely. This latest move is on the pretext of national security, and that makes it much harder for other countries to respond to it without setting aside the rules themselves.

It also makes it clearer than ever that, unlike many other subjects on which Mr Trump is wrong but not terribly invested, trade is an area of his policy ignorance that he cares about deeply. He appears genuinely to believe that tearing up the rules on which international trade is based will make America great again, and that the trade war which could well follow is an easily winnable part of the process.

Protection

Membership of the WTO means forgoing the option of squeezing foreign rivals with trade restrictions. In return it provides secure access to foreign markets along with specific remedies should you feel you are the victim of dodgy trade practices.

Among these remedies is the option of imposing new tariffs if you find yourself facing imports that are surging, subsidised or being sold below cost. America's steel industry has a long history of receiving such protection. In March 2002, for example, George Bush imposed a safeguard tariff—the sort of blanket duty that is

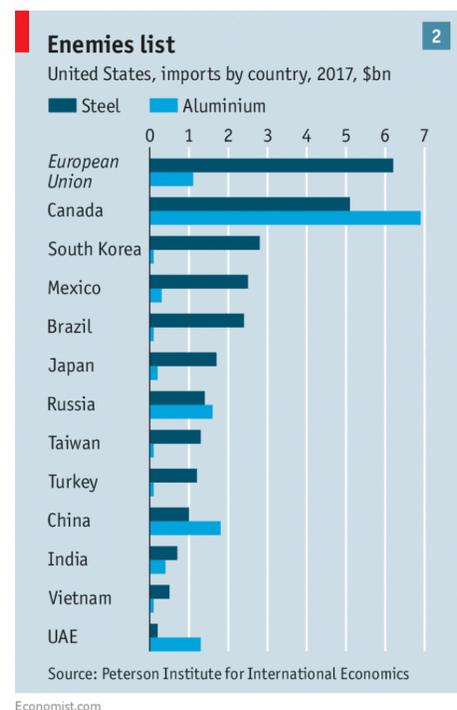
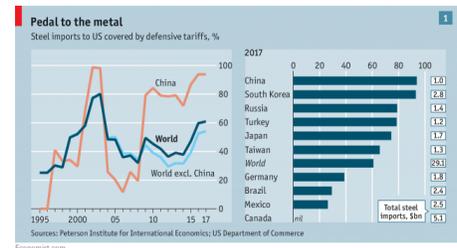
used against surges in imports—of up to 30% on steel. He backed down, but defensive tariffs still apply to three-fifths of American steel imports (see chart 1).

What is unprecedented about the new tariffs is thus not their purpose. Nor is it their likely impact. Ronald Reagan's protectionist policies distorted the world economy more than Mr Trump's latest actions are likely to in and of themselves, says Douglas Irwin, a trade expert at Dartmouth College.

It is the legal rationale being used to justify them that stands out. Mr Trump is using Section 232 of the Trade Expansion Act of 1962, which provides for action based on a threat to national security. This has previously been used in just a handful of cases, mostly related to oil.

Reports released by Mr Trump's commerce department on February 16th found that Section 232 could be used to restrict steel and aluminium imports because America's armed forces and "critical industries" need a domestic supply of steel which imports are putting at risk. This is bunkum. Gary Hufbauer of the Peterson Institute for International Economics, a think-tank, notes that the administration's aim of having domestic steelmakers working at 80% or more of their capacity has nothing to do with how much speciality steel is actually used by the defence department: the report was "totally cooked".

Jennifer Hillman of Georgetown University, who has been both a commissioner on the United States International Trade Commission and a judge on the WTO's appellate body, finds the national-security justification particularly questionable given that most of the steel imports come from Canada, the European Union (EU), Mexico and South Korea (see chart 2). The steel tariffs will barely scrape China, the Trump administration's greatest trading—and putative military—foe. Adding to the sense that the national-security argument is a sham is the fact that the tariffs on aluminium—where imports from Russia and



China matter more—are less than half what they are on the steel made by allies.

America's trading partners think these tariffs break WTO rules. In a normal situation, the WTO would offer them a way to complain. The standard procedure is that the judges in Geneva get to say whether a tariff violates the WTO commitments of the country imposing it. If they find that it does, the countries hit by the tariffs can retaliate in ways of their own devising with the WTO's blessing, up to a certain limit. In the case of Mr Bush's steel tariffs, the EU took aim at exports from politically salient states, such as orange juice from Florida.

There is, though, a snag. Article XXI of the WTO treaty allows a member to raise any tariffs "it considers necessary for the protection of its essential security interests" even if there is no evidence that imports are surging, subsidised or sold below cost. Invoking Article XXI allows you to do anything you like, and thus endangers the whole system—which is why, given that the system is one which members have chosen to join and which they value, it is very rarely invoked. It is a nuclear option.

The power of Article XXI puts countries which might challenge Mr Trump's tariffs in a jam. If they do not make a case at the WTO but retaliate anyway, they have given up the high ground and things will probably escalate. If they neither challenge nor retaliate, they keep the moral high ground—but Mr Trump will claim victory, which will be galling, and will quite possibly be emboldened to go further. This will also be the case if they challenge and the court sides with America—which, given the broad exception for national security that Article XXI provides, is quite likely. And if they challenge and win they will have brought about the unedifying spectacle of a panel of judges in Geneva telling a sovereign nation that they know where its security interests lie better than its president does. That would not go down well.

All this helps explain why, on the dozen or so occasions in the past 70 years when Article XXI has been invoked, the issue has never gone far enough for the court to have to make a ruling. By appealing to national security, rather than making a case of the sort the court normally rules on, Mr Trump is blocking the mechanism that sanctions limited retaliation and thus stops trade disputes from blowing up.

You could see this as tactically astute. But it sets a terrible precedent. If a country of America's heft gets away with justifying protection on blatantly spurious national-security grounds, what is to stop members like India or China doing the same? Bad behaviour has spread in the past. In 1956 America had its agricultural sector exempted from rules limiting state support—only to see the European Community, as the EU then was, using the same exception a few years later to create its common agricultural policy, a grotesquely distorting system of subsidies that American negotiators went on to spend decades trying to curb.

Tariffing possibilities

All this comes when the rules-based trading system is already stalled and thus vulnerable. The WTO, and before it the General Agreement on Tariffs and Trade (GATT), used to update themselves every so often through rounds of negotiation designed to spread the benefits of trade wider in ways on which all could agree. This process meant some issues got solved, and those that did not could plausibly be put off to the next round. But disagreements between rich and poor countries over whether the poor should get special treatment in the name of development mean that no new round has been completed for more than 20 years. Things that really ought to be dealt with have thus just kept piling up.

Muddling along with the status quo might have been acceptable if global trade had stayed pretty much the same, too. But it didn't. China, which joined the WTO in 2001, brought to the party a model of trade-distorting state-infused capitalism beyond anything the existing rules had been shaped for.

Desperately in need of new rules but unable to create them, the WTO has been disappointing many of its members, perhaps none more so than America. Digital trade remains outside the WTO system. Services are inconsistently covered. Without new rules, its judges have found themselves interpreting the ambiguities in old ones in a way that looks to some like overreach. The organisation has been able to do little to stop China's state-owned enterprises from exporting the surpluses created by their subsidised overcapacity, thus overwhelming producers elsewhere.

Lawyers like Robert Lighthizer, the United States Trade Representative, grumble that the WTO has allowed China to take advantage of everyone else and its outdated

rules have stopped America protecting itself. The WTO's judges have repeatedly ruled that America's trade defences are tougher than can be justified given the commitments it has made.

With enough squinting, you can draw an intellectual path between America's mostly reasonable diagnosis of the WTO's problems and some of its actions. For example, Mr Lighthizer is trying to force change on the body's judicial arm by blocking appointments to its court of appeals. He claims that he is trying to reform, not break, the system.

It is harder to connect the WTO's shortcomings with Mr Trump's tariffs. Massive overcapacity (which now, admittedly, is being reduced somewhat) means that China really is a problem. But anti-dumping and countervailing duties have already shut most Chinese steel out of the American market. And the tariffs will alienate WTO members with which America might otherwise make common cause. In December 2017 America, the EU and Japan released a joint statement saying that they would work together to combat "market distorting and protectionist practices"—by which they meant "China". That looks harder now. To add to the incoherence, America is no longer pursuing a WTO case against Chinese aluminium subsidies started by Barack Obama's administration in 2017. Instead of helping keep China's rise within the rules, Mr Trump is providing a distraction from it.

War games

How bad is all this? Mr Irwin says that people sometimes view the history of the post-war trading system with rose-tinted glasses. When Reagan was using America's clout to bully his trading partners into "voluntary export restraints" which exploited gaps in the GATT's regulations, many worried the world was shifting to a trading system anchored in brute power, not multilateral rules.

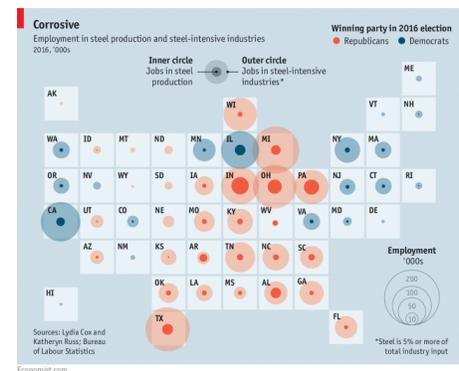
That said, Mr Irwin continues, Reagan always believed in the system; ultimately, his frustration was that it was too weak. His trade-retaliation efforts were always supposed to be temporary—a crude means towards a stronger system. This aggression was one of the reasons why, in the 1990s, countries signed up to stronger rules under the WTO. Mr Trump is no such believer.

For a better parallel, look not to the 1980s but to the 1920s and 1930s. When the House passed the first bit of the legislation which eventually became the infamous Smoot-Hawley Tariff Act in 1929 America's economy was growing and unemployment was low. By the time President Herbert Hoover passed it in 1930 the world had slumped into recession. The ensuing trade war made a dire situation worse.

A better parallel is not a perfect one. The world is not about to return to the 1930s. But there is still scope for a lot of harm, in the steel industry and beyond.

American steel imports account for about a third of the country's steel use, and around 7% of the world's total trade in the metal. According to the commerce department a tariff of 24%—the level it recommended—would have been enough to crimp imports by a third in 2017, equal to roughly 10% of demand.

What does that mean for jobs? An analysis by the Trade Partnership, a consultancy, predicts that increases in the price of steel and aluminium under these tariffs will, in the short-term, create 33,000 metal-making jobs and destroy 179,000 metal-dependent ones. Mr Trump is thus screwing over two Rose Bowls of people for the sake of one Fenway Park. In the context of the whole economy, though, such numbers are not that big. America added more than 2m net jobs during the past year.



At the scale of the national economy, the direct costs of the tariffs are expected to be minor; they will have a very small effect on growth, as they will on individual consumers. An official study of President Bush's somewhat smaller safeguards estimated their net negative effect on GDP to have been a paltry \$30m (0.0003%).

The real danger to America comes with the second- and even third-round effects. Mr Navarro said on March 2nd that he thought exporting countries would turn the other cheek, concerned over losing access to America's other markets. That may be true for some, perhaps even including China. But in other cases Mr Navarro's view seems naive.

The biggest question is over Canada and Mexico, the other two members of the North American Free-Trade Agreement (NAFTA). In 2016 Canada sold 88% of its steel exports to America, Mexico 73%; a continent-wide web of supply chains links all three economies. Under Mr Bush's steel safeguards, both neighbours were exempt. Some of the steel and aluminium companies arguing for protection have been fighting for Canada to be excluded this time, too. The White House has seemed to promise carve outs for Canada and Mexico, and perhaps other allies. But Mr Trump has tweeted that such exemptions would depend, perhaps in the long term, on the other two countries giving him the concessions that he wants in NAFTA renegotiations. Both the Canadian and Mexican governments have said that, if hit by tariffs, they will strike back quickly and decisively.

The EU—which sells more steel to America by value, if not by volume, than anyone else—has also said it will retaliate, and has been specific about how. It has promised to launch a formal WTO dispute, and is poised to impose its own steel safeguard measures should it face a surge of imports turned away from America. “If the EU does not act, our steel industry will pay the bill for protectionism in the US,” warned the head of WV Stahl, Germany's steel-industry trade group.

The EU has also drawn up a list of American exports it would hit with a “reciprocal” 25% tariff for a total of €2.8bn (\$3.5bn) It includes cranberries, €400m of bourbon, and Harley-Davidson motorcycles. Bourbon is made in Kentucky, the home state of Mitch McConnell, the Republican leader in the Senate. Harleys are made in Wisconsin, the home state of Paul Ryan, Speaker of the House—which is also, as luck would have it, America's top cranberry producer. As Jean-Claude Juncker, president of the European Commission, puts it, “We can also do stupid.”

In fact, the EU's strategy is more intelligent than Mr Juncker makes it sound. Its officials have calculated that, if the Americans had called the steel tariff a safeguard, under WTO rules the EU would have been entitled to retaliate within 90 days to the tune of €2.8bn, because some of its steel exports to America have not been rising. If the WTO judges were to ignore America's national-security folderol—and there may yet be some legal precedent for their disagreeing with a member state about the nature of the tariffs it is raising—they could well rule the EU's proposed retaliation proportionate and legitimate.

Ms Hillman calls this approach clever, as Mr Trump's tariffs are "going to function much more like a safeguard than anything else." By sticking to the spirit of the law the EU can claim to be a defender of the rules-based system, while attacking one of Mr Trump's two weaknesses (beyond ignorance) as a trade warrior: the congressional Republican leadership, which is already much more keen on free trade than he is, and would rather Mr Cohn had carried the day in the White House. The other weak spot is the stockmarket, which is already jittery, and could get a lot more so if signs of a trade war get much stronger.



No protection

Ideally the EU's cunning plan would save the day before the judges in Geneva have to come to any potentially explosive decision about Article XXI. But its strategy is untested. And Mr Trump seems likely to take even a proportionate retaliation badly. He has said that he would meet such a response with tariffs on cars. Given that America imported €38bn of cars from the EU in 2016 that would be a big escalation.

He has fairly free rein in such matters. The constitution vests powers over trade in Congress. But some of it has been shifted to the executive, in part because no one ever thought the president would be more protectionist than Congress. Section 301 of the Trade Act of 1974 gives the president retaliatory rights if a trading partner discriminates against America. Mr Trump could use it against European cars. The administration is also considering a Section 301 action which would allege, it is said, that Chinese technology companies have stolen \$1trn or more from America. If that goes ahead, it will open up a far larger second front in the nascent global trade war. If Mr Trump decides to go for broke, the International Emergency Economic Powers Act of 1977 allows the president to declare a national emergency and impose restrictions on all forms of international commerce.

If the worst happened and America did retreat from the rules-based system, its other 163 members would be unwilling to follow, even under provocation. The system is far from perfect. Frustrations with its rules can be seen in the

proliferation of separate trade agreements, and are clear in the rising pressure on its judicial arm as its negotiating one lies broken. But the secure market access, freedom from trade discrimination, and limits on escalation that the system offers its participants have in large part been realised, as the astronomical rise in global trade over the past half century bears witness. For all the pressures imposed by China's emergence, lifting millions of people out of poverty is not to be sniffed at. Members like India, South Africa and China have been tugging at the pages of the WTO's rule book. But only one person wants to tear it up.



On March 1st Mr Lighthizer unveiled the Trump administration's trade agenda. It admiringly quotes George Washington saying that "there can be no greater error than to expect, or calculate upon, real favours from nation to nation." The first president, it points out, advised that trade agreements should be "temporary," and "abandoned or varied, as experience and circumstances shall dictate." This embrace of unreliability and uncertainty suits Mr Trump to a T. It is the opposite of everything the rules-based system stands for.

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