The Long View: The Political Risks of Free Trade

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This note delves into the political aspects of trade that often get overlooked in economic and business dialogues. It updates and extends a March 22 assessment.

Notions of a broadly destructive trade war may be overblown

Trade relationships are complex and dynamic and there are many cross-cutting forces that defy simplistic assertions.

- Because of the large trade surpluses China, Mexico, Germany, and other countries have with the US, **surplus countries have more to lose in the near term** in any trade war scenario. Their economies are also much more dependent on exports. While China has reciprocated tit for tat so far, it cannot ultimately match the leverage of the US. In its June global economic outlook, the World Bank concluded that the countries likely to be hardest hit by increased protectionism would be emerging markets. A full-blown trade war, resulting in a 9% drop in global trade (the same drop seen in 2008), would depress global growth by one percentage point, the bank concluded.

- While Beijing can be nimble with policymaking, President Xi Jinping's administration faces many **conflicting domestic interests regarding trade and protectionism.** The Chinese economy is showing softness as the government tries to constrain lending, and the leadership is worried about tariffs precipitating a drop in foreign direct investment and manufacturers shifting production to lower-cost locations. Chinese tariffs on US agricultural imports will spur domestic food price inflation, and, while the government has spurred anti-Japanese and anti-Korean sentiment in past trade disputes, it is not clear how effective an anti-American propaganda campaign would be.

- **Many technological and economic drivers of trade mitigate against a destructive economic warfare scenario**. An important near-term issue to watch is foreign exchange effects. For example, if the US scraps NAFTA, the Mexican peso and Canadian dollar are likely to devalue further than they already have this year, counteracting increased export costs. Over the medium term, businesses will blunt the effect of tariffs by shifting supply chains and cutting costs, through automation, for example. Should NAFTA be scrapped, higher tariffs will not offset Mexico's cheap labor costs, which are about 1/7 those in the US.

- Despite many warnings from the business and investor communities, it is not clear when trade tensions will start driving down growth prospects. Global markets have generally remained buoyant. Addressing Congress on July 12, Treasury Secretary Stephen Mnuchin noted that the US government had yet to detect any deleterious economic effects from the administration's trade moves. **President Donald Trump has been able to pursue his trade agenda because the US and global economies are so strong.** Should US growth start to slow appreciably, it is likely he would moderate his position. ▶

Rising protectionism will have unequal effects on business

- **Small and medium-sized firms are likely bear the brunt of rising protectionism.** Many SMEs have been able to globalize their footprint thanks to lower costs and greater ease of doing business in a free trade environment. Should NAFTA go away, companies will face a surge in administrative costs to comply with new rules and regulations. Smaller companies that manufacture in China and export back to the US often lack the flexibility or agility of larger enterprises to move their operations to other parts of Asia, so increasing costs and complexity would likely lead to consolidation among smaller companies in the US and abroad.

- Large companies typically have more diversified supply chains and business models as well as more market power to pass on cost increases. They also tend to have more visibility and lobbying power. **Those with "charismatic" products, such as mobile phones and automobiles, are less likely to be directly targeted by protectionist measures** than manufacturers of primary and intermediate goods such as plastics and components, which are less visible to policymakers and consumers.

- **The potential demise of NAFTA would also have unequal effects** as trade with Mexico would be more heavily affected than that with Canada**.** The US-Canada bilateral free trade agreement would become the default terms for trade, so, for example, the rules governing Canadian oil and gas exports to the US would not significantly change. Nonetheless, the headlines about the trade war are depressing the value of the Canadian dollar and making Canadian oil and gas more competitive.

It is important to distinguish between the economic and political rationales for free trade

While the macroeconomic merits of free trade have been supported by centuries of research, the political foundations to sustain free trade are less robust and they are rapidly evolving.

- Regardless of how the economic relationship is sliced and diced, **US-China trade is not balanced, and it is often not fair.** The international business community has talked, quietly, for years about a lack of trade fairness in China that the White House is now taking up in its own manner. Similarly, the Europeans have grown increasingly concerned with China and are now worried that Chinese producers that suffer from overcapacity will divert more cheap steel and aluminum to the European market. Fairness, and for whom, must be addressed when talking about trade.

- While global firms are big beneficiaries and vociferous supporters of free trade, the **macroeconomic benefits are much more diffuse for the average worker or consumer.** On the other hand, the topic of layoffs and plant closures—for whatever cause—is very compelling. And as the US has opened its markets over the past several decades, adequate mitigation efforts for job dislocation have not been put in place. Moreover, it is not easy to train, retrain, and relocate workers—especially those with limited skills and economic means.

- **The benefits of free trade are not evenly distributed by region.** Global gateway cities such as Los Angeles, New York, London, and Paris are prospering while their hinterlands just 100 miles away are lagging. This has created the perception that the benefits of free trade accrue disproportionately and globalization leaves the losers to fend for themselves. NAFTA was pitched as a way to promote prosperity and reform in Mexico, but over the past 25 years, deep poverty and economic exclusion have not improved and migration pressures ▶

have persisted. In Mexico's July 1 election, economic stagnation and insecurity, lawlessness, and corruption were top voter concerns, especially in rural areas and the south.

Trade policy is increasingly conflated with other political and geopolitical forces

- The trade drama is occurring within a much larger political context in the US and elsewhere and is characterized by **a pervasive sense of personal insecurity** related to slow wage growth, tech-driven job redundancy, and the rapidly rising costs of education, housing, and healthcare. Establishment politicians are seen as remote and ineffective at dealing with these structural challenges, and Trump is adept at political theatricality that builds up and plays off these concerns. Similar forces are at work in the UK, Italy, and France and are unlikely to dissipate in the foreseeable future.

- **The White House is adept at political theater and it has been very effective at aligning its trade push with other policy issues** such as regulation, the courts, immigration, collective security, protecting blue-collar jobs, and the fate of the manufacturing economy. In the process, Trump has reshaped the Republican policy agenda and its political calculus. While China and the EU have targeted their countermeasures at agricultural and swing states, GOP politicians that are not retiring have not presented significant resistance to Trump's actions on trade.

- US-China economic tensions are rising in tandem with a growing sense that **China has become a formidable geostrategic competitor**—in the South and East China seas, in cyberspace, and with its Belt and Road and Made in China 2025 ambitions. It is important to note that on the same day the White House announced its intellectual property–related sanctions, the head of the Federal Bureau of Investigation testified to Congress that Chinese economic and political espionage is pervasive and China is increasingly pursuing political influence tactics similar to Russia's. Despite macroeconomic costs, the trade relationship was bound to come under pressure as the US-China geostrategic standoff heats up.

A number of risks bear watching

- The White House's trade actions come at a time when some economies are starting to slow and there are questions about the sustainability of global final demand. Rising US interest rates also are creating stresses in the global economy. The US trade actions create uncertainty about supply chains, consumer responses, and investment plans and **could generate negative impacts that are hard to predict.**

- Investment flows, as well as trade, are at stake. What has not received as much attention is the Trump administration's much stricter use of the Committee on Foreign Investment in the United States's process **to restrict proposed foreign investment** that is perceived as a strategic threat. Proposals in Congress to significantly expand the jurisdiction of the committee could have a significant long-term impact on cross-border trade and investment. In the past, when has Washington increased scrutiny of and restrictions on FDI, other countries clamp down.

- While China has a limited ability to impose retaliatory tariffs on US goods, **Beijing has a wide range of nontariff barriers it could impose**, such as increasing regulatory oversight and slowing customs and permitting processes. Beijing has pledged to liberalize parts of the economy, such as financial services, aviation, and automobiles, which could allow regulators to give preference to European- and Asian-based companies and freeze out US firms. ▶

- Washington's trade actions have infuriated Beijing and **China is likely to take more adversarial stances on a host of pressing geopolitical issues**, such as the reimposition and enforcement of sanctions on Iran, negotiations to compel North Korea to denuclearize, efforts to constrain cyberwarfare, and the militarization of the artificial islands it has built in the South China Sea. Meanwhile, Washington's unilateralism is alienating it traditional allies and enabling Beijing to take the diplomatic high ground on defending multilateralism, rules-based global governance, and globalization.

- It bears repeating that because Trump's decision-making is highly unconventional and erratic, **there is no clear endgame in his trade actions other than the disruption of long-established norms, rules, and relationships.** Despite outward statements of optimism, some Mexican and Canadian officials working on NAFTA renegotiation privately concluded this spring that there may be no significant deal to be had with the White House given its hard stances on issues such as the sunset clause, automotive rules of origin, and dispute resolution. Beijing has tremendous incentive to avoid economic conflict with the US, and it, too, has been gamely looking to cut a deal with Washington. In a March letter to the Chinese government, Trump stated that his goals were to quickly cut the trade deficit in half, curtail the Made in China 2025 innovation strategy, and gain greater access for US companies to large segments of the Chinese market. These steps would essentially cripple China's development model—a nonstarter for an ambitious regime that is pushing hard to make China great again.

- **In this context, US trade and investment relations with China and its other key partners are likely to get worse before they get better.** ■