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The False Promise of Protectionism

Why Trump's Trade Policy Could Backfire

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In his inaugural address, U.S. President Donald Trump pledged that economic nationalism would be the hallmark of his trade policy. “We must protect our borders from the ravages of other countries making our products, stealing our companies, and destroying our jobs,” he said. Within days, he withdrew the United States from the Trans-Pacific Partnership (TPP), announced that he would renegotiate the North American Free Trade Agreement (NAFTA), and threatened to impose a special tax on U.S. companies that move their factories abroad.

Although Trump's professed goal is to “get a better deal” on trade, his brand of economic nationalism is just one step away from old-fashioned protectionism. The president claimed that “protection will lead to great prosperity and strength.” Yet the opposite is true. An “America first” trade policy would do nothing to create new manufacturing jobs or narrow the trade deficit, the gap between imports and exports. Instead, it risks triggering a global trade war that would prove damaging to all countries. A slide toward protectionism would also undermine the institutions that the United States has long worked to support, such as the World Trade Organization (WTO), which have made meaningful contributions to global peace and prosperity.

At the same time, not all tariffs are bad. Congress is considering corporate tax reforms that would involve a “border adjustment tax”—a tax that would apply to all imports to the United States but not to exports. If implemented fairly, such a measure would not be protectionist.

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Likewise, not all trade threats are bad. Although it is true that closing the market to foreign competition is the wrong way to improve U.S. economic performance, the threat of closing the market has sometimes helped ensure compliance with international trade rules. But this is a high-risk strategy that must be used with care, since it could spark damaging foreign reprisals.

It is all the riskier given the growing nationalist sentiment around the world. According to the WTO, the import restrictions imposed by G-20 countries since 2008 now cover a disturbingly high 6.5 percent of their merchandise imports. The rate at which new measures are being imposed exceeds the rate at which old measures are being removed,

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resulting in the steady accumulation of trade barriers. In January, citing “protectionist pressures,” the World Bank reduced its forecast for global economic growth in 2017.

In this environment, a move toward protectionism by Washington could unleash a similar response abroad. Such a scenario has a historical precedent: when Congress passed the Smoot-Hawley Tariff Act in 1930, it was taken as “the signal for an outburst of tariff-making activity in other countries, partly at least by way of reprisals,” as a League of Nations report explained at the time. Washington should not send that signal again.

As the Trump administration plots its next move, it should take care to distinguish between what trade policy can achieve and what it cannot, and between changes to current policy that would be constructive and those that would prove counterproductive. It must also recognize that protectionism at home can lead to protectionism abroad. Indeed, perhaps the greatest danger of Trump’s trade policy is that a misstep might do irreparable damage to the open world trading system that the United States had, until now, so assiduously promoted since World War II. That system constrains the policies of the 163 other WTO members, with which the United States trades. If the United States backs away from current trade rules, those countries will feel free to discriminate against the United States, and the system will unravel—doing grave damage not only to the global economy but also to the very Americans Trump claims to represent.

THE PERILS OF PROTECTIONISM

Although free trade is always under fire, the barrage has been particularly intense in recent years. U.S. politicians often blame trade for the loss of manufacturing jobs and the destruction of the middle class, and many voters seem to agree. It was Trump's willingness to acknowledge the "rusted-out factories scattered like tombstones across the landscape of our nation" and to question establishment views on trade agreements that won him support in the Rust Belt.

But the reality is that factors other than foreign trade are to blame for the country's current economic woes. The share of Americans who work in manufacturing has fallen steadily since the early 1950s, mainly due to automation and productivity growth. The labor-force participation rate among working-age males has been declining since 1960. The stagnation in real earnings of men also dates back to the early 1960s. These trends started well before the era of deregulation and free trade in the 1980s and 1990s, let alone the "China shock" of the first decade of this century. Complaints about the plight of middle-class workers resonate so much today, however, because the U.S. labor market has experienced more than a decade of lackluster performance, owing to the slow recovery from the 2008 financial crisis. Since then, trade has not significantly disrupted the U.S. labor market because imports have not been surging into the country.

The problem with wrongly blaming trade for these recent difficulties is that it makes it all too easy to propose protectionism as the quick fix. After all, if imports are seen as the problem, then reducing them—by reversing existing trade policies, tearing up NAFTA, or slapping high duties on Chinese goods—would seem to be the solution. Yet simply rolling back trade will not repair the damage that has been done. Those who want to curtail trade claim that such actions will revitalize basic manufacturing industries, create new manufacturing jobs, and reduce the trade deficit. In fact, higher trade barriers would fail to achieve any of these objectives.

Why can't trade protection be used to revitalize basic industries that have suffered? After all, some claim, in the 1980s the Reagan administration imposed many import barriers, which seemed to help domestic industries cope with increased foreign competition. Confronted with a large and growing trade deficit, the United States pressured Japan to agree to reduce its automobile exports, forced foreign suppliers to limit their steel exports, and negotiated

a new arrangement that restricted imports of textiles and apparel. Because the economy recovered and employment grew, Robert Lighthizer, a trade negotiator in the Reagan administration whom Trump has tapped to be the U.S. trade representative, has asserted that Reagan-era import restrictions “worked.”

But that judgment runs counter to the evidence. In a 1982 report, the U.S. International Trade Commission found that most industries receiving trade relief were undergoing long-term declines that import restrictions could not reverse. Such measures did little to help companies, it stated, “either because so much of the firm’s injury was caused by non-import-related factors, or because the decline of imports following relief was small.” Four years later, when the Congressional Budget Office studied the question, it concluded, “Trade restraints have failed to achieve their primary objective of increasing the international competitiveness of the relevant industries.”

Just as it is today, trade then was wrongly blamed for the problems facing U.S. producers. What really afflicted them were factors beyond the reach of trade policy. The first was a cyclical problem: the severe recession in 1981–82 that resulted from the tight monetary policy the U.S. Federal Reserve had adopted to reduce inflation. That policy contributed



to a 40 percent real appreciation of the dollar against other currencies between 1981 and 1985, making U.S.-made goods far less competitive at home and abroad. Then there were various structural problems: Big Steel lost market share to low-cost domestic mini-mills that could recycle scrap metal, and the Big Three automakers were slow to improve quality and shift to the smaller, more fuel-efficient cars that consumers were demanding. Eventually, U.S. producers did regain their competitiveness, but they did not do so thanks to protectionist policies. Credit goes instead to the economic recovery that started in 1983 and the weakening of the dollar that started in 1985.

One should look back at the Reagan-era protectionism not with nostalgia but with regret, because it proved to be a costly failure. The restrictions on automobile imports raised the average price of a Japanese car by 16 percent in the early 1980s, socking it to consumers and handing billions of dollars to Japanese exporters. The limitations on steel imports punished steel-using industries, and those on textile and apparel imports raised prices for low-income consumers. When it comes to using protection to help revitalize domestic industries, the United States has been there, done that. It didn't work.



BAD BARRIERS

Today, the prospect that import restrictions can help domestic producers is even dimmer than it was in the 1980s. That's because firms engaged in international trade now form part of intricate global supply chains. About half of all U.S. imports consist of intermediate goods, such as factory equipment, parts and components, and raw materials. Many U.S. companies depend on imported intermediate goods in their production process or sell their outputs to other firms around the world that use them as inputs. As a result, protectionist measures today would prove much more disruptive than they did in the 1980s.

The implications for trade policy are enormous. Any import restriction that helps some upstream producers by raising the prices of the goods they sell will hurt downstream industries that use those goods in production. If a tariff raises the price of steel to help U.S. Steel, it will hurt steel consumers such as John Deere and Caterpillar by raising their costs relative to those of foreign competitors. If a quota keeps out imported sugar to boost domestic prices, it will raise costs for the domestic confectionery industry. (Indeed, in 2002, Kraft moved the production of Life Savers candy to Canada in response to the high cost of sugar in the United States.) Typically, there are far more workers in the downstream industries whose jobs will be jeopardized by trade restrictions than workers in the upstream industries whose jobs might be saved by them. In an effort to help the 147,000 Americans employed in the steel industry, for example, Washington may harm the 6.5 million Americans employed in steel-using industries.

Even if trade protection can succeed in helping some domestic producers at the expense of others, it is an illusion to think that it will create many new manufacturing jobs, particularly for low-skilled workers. In the United States, manufacturing has become technologically sophisticated and involves many more engineers and technicians than blue-collar workers on the assembly lines. The clock cannot be turned back. Consider the steel industry: in 1980, it took ten man-hours to produce a ton of steel; today it takes just two. So boosting steel output will not create nearly as many jobs as it would have in the past.

Even if a particular trade measure succeeds in terms of protecting jobs in a specific sector, it will cost consumers dearly. When the Obama administration imposed special duties on tires imported from

China in 2009, the measure saved at most about 1,200 jobs—at a cost to consumers, in the form of higher tire prices, of \$900,000 per job. And by pushing U.S. production toward the types of lower-quality tires that the United States had been importing and away from the high-quality tires that U.S. producers specialized in making, the tariff froze American workers in low-end jobs at the expense of high-end ones. No country can protect the jobs of the past without losing the jobs of the future.

Another reason trade protection today makes even less sense than it did three decades ago is that other countries are sure to retaliate in a way that they did not before. Back then, the United States demanded that other countries restrict their exports to the United States. Because foreign suppliers reduced their exports themselves to avoid U.S. punishment, they were able to charge much more for these suddenly scarce goods and earn exceptionally high profits. Although countries such as Japan did not always like restricting their exports, they did not strike back because the United States was not imposing tariffs on them.

Today, such export restrictions would violate WTO rules. If the United States nonetheless arbitrarily imposed steep tariffs or other trade restrictions on imports, other countries would inevitably retaliate against U.S. exports. That would directly threaten U.S. farm and factory workers. In a report released last year, the Department of Commerce estimated that 11.5 million U.S. jobs were supported by exports. Those jobs—which tend to pay above-average wages for manufacturing—would be jeopardized if the United States started slapping taxes on imports. Protectionism is a game that more than one country can play.

Foreign retaliation could even occur if the measures were permissible under WTO rules. In the past, whenever the United States slapped duties on Chinese imports under antidumping provisions allowed by the WTO, China's regulators would suddenly find that U.S. poultry or pork was contaminated and had to be banned, its airlines would start buying from Airbus instead of Boeing, or its food companies would purchase Argentine soybeans and Australian wheat rather than the American equivalents.

The mix of macroeconomic policies Trump has promised will likely enlarge, rather than shrink, the trade deficit.

Finally, protectionism damages the U.S. economy even when no one retaliates. Trade restrictions increase the price of imported goods—not just for businesses that employ workers but for households, too. The higher prices that these consumers pay for goods affected by import restrictions reduce the amount of money they can spend on other goods. To make matters worse, tariffs on imports also act as a kind of regressive tax. Because poorer households tend to spend proportionately more of their income on tradable goods such as food, clothing, and footwear, they bear a disproportionate burden of import restrictions. You wouldn't know it from listening to most politicians, but low- and middle-income households benefit substantially more from trade than do high-income households.

THE TRADE DEFICIT FALLACY

Import barriers are often proposed as a way to shrink the trade deficit, a particular bugbear of Trump's. Yet it is far from clear that reducing the trade deficit should be a policy priority. Unlike in the 1980s, when the current account deficit was growing rapidly, today, it has remained stable for nearly a decade, at about two to three percent of GDP. Imports are not flooding into the United States; in fact, in 2016, the value of U.S. imports from China fell by four percent from the previous year. Even if one believes that closing the trade gap would boost employment—and the consensus among economists is that it would not—past experience suggests that restricting imports alone would fail to narrow the deficit. The United States had a trade surplus when it imposed the Smoot-Hawley Tariff, but exports fell in step with imports and the trade balance did not budge. In the 1980s, the trade deficit continued to grow in spite of the Reagan administration's protectionist measures.

The trade deficit is impervious to import restrictions, particularly in an era of floating exchange rates, because it is determined not by trade policies but by net capital flows into the United States. As economists have long emphasized, unless domestic savings rise (a good thing) or national investment falls (a bad thing), the United States will be a recipient of capital from abroad. Because the dollar is the world's reserve currency, the closest thing to a safe asset in the global financial system, foreign demand for dollar-denominated assets will remain strong. The continued demand for safe assets means that other countries will use some of their dollar earnings to buy U.S. assets

instead of U.S. goods. This, in turn, means that the United States will continue to buy more from other countries than they do from it.

Ironically, even though Trump has said that he wants to reduce the trade deficit, the mix of macroeconomic policies he has promised will likely enlarge, rather than shrink, it. Just as the Reagan administration discovered, the combination of an expansionary fiscal policy (Trump has promised lower taxes and greater infrastructure spending) and a tighter monetary policy (the Federal Reserve's ongoing response to falling unemployment) will cause the dollar to appreciate against other currencies. In the 1980s, these policies dealt a painful blow to U.S. companies that exported goods or competed against imports. The result was a growing trade deficit and louder calls for protectionist measures. Over the past three years, the dollar has already risen by more than 25 percent compared with other currencies. If the Federal Reserve continues to tighten monetary policy and the fiscal deficit continues to grow, the trade deficit will likely grow, too, despite Trump's trade policies.

LEVELING THE PLAYING FIELD

Even though the case against protectionism remains strong, that does not mean that activist trade policies have no role to play. One thing the Reagan administration did that the Trump administration could usefully emulate was to undertake strong trade-enforcement measures.

Ronald Reagan always insisted that free trade required enforcing the rules. As he put it, "When governments assist their exporters in ways that violate international laws, then the playing field is no longer level, and there is no longer free trade." That's why his administration pursued trade agreements: to establish rules to constrain unfair policies. And yet to reach such agreements, it is sometimes necessary to threaten higher trade barriers. Supporters of free trade often object to such tactics, but even Adam Smith argued that it might be worthwhile for a country to threaten to close its market if the move brought about a change in foreign behavior. Although the Obama administration filed many new cases involving specific products and specific countries with the WTO, such a piecemeal approach falls short of addressing a real and growing problem: whether international competition between private domestic firms and foreign state-owned or state-supported firms can ever truly be fair.

The problem is most acute when it comes to China. China's state banks routinely engage in generous and unprofitable lending that leads

to excess capacity in various industries, such as steel. China produces half of the world's steel, and as its economy has slowed, massive excess capacity has built up in that sector. In a market system, unneeded plants would shut down. But in China, the visible hand of the state is at work, as government-owned banks prop up uneconomic production capacity with cheap credit. China then dumps its surplus steel on other countries, where calls for protectionism grow.

Free-trade supporters are of two minds about foreign subsidies. On the one hand, these subsidies reduce the price paid by U.S. consumers, who should send a thank-you note to foreign taxpayers for their generosity. On the other hand, foreign subsidies distort markets in a way that is costly not only to the subsidizing country but also to other countries. In the countries importing the subsidized goods, plants are idled and workers are laid off—adjustment costs that the subsidizing country avoids. A political backlash can result: when foreign subsidies harm an important domestic industry, free trade gets a bad name and becomes a harder sell at home. As a result, the United States has tended to err on the side of opposing foreign subsidies. It has, for example, attacked Europe's agricultural subsidies as detrimental to American farmers and its subsidies to Airbus as a threat to Boeing, and it has sought agreements to rein in both.

So how should the United States respond to, for example, Chinese steel subsidies? Imposing antidumping duties is not the answer, since they would fail to solve the underlying problem of excess capacity and would punish steel-consuming industries in the United States. Paradoxically, however, threatening reprisals of some sort may be the answer; politely asking China to cut back its steel subsidies would accomplish nothing. Confronting unfair trade practices with the threat of retaliation is not protectionism in the usual sense. Instead, it represents an attempt to free world markets from distortions. In order to return trade to a market basis, Washington may have to threaten trade sanctions, some of which might have to be carried out for the threats to gain credibility. This process will no doubt be disruptive and controversial, but if handled skillfully, the end result could make it worthwhile.

Once again, the 1980s offers useful lessons. In 1985, Reagan used the power granted to him under a provision of U.S. trade law known as Section 301 to attack unfair foreign trade practices, such as the barring of U.S. products from certain markets. Although the U.S.

action prompted bitter foreign protests, Arthur Dunkel, the Swiss director general of the General Agreement on Tariffs and Trade (the predecessor to the WTO), later admitted that it was one of the best things the United States had ever done for the multilateral trading system: it helped unite the world behind an effort to strengthen the rules-based system in the 1986–94 Uruguay Round of international trade negotiations. The WTO's dispute-settlement system has proved remarkably successful and should be supported, but it may not be capable of handling every type of trade disagreement.

A border adjustment tax is another policy currently under consideration that is sometimes labeled as protectionist but need not be. Republicans in the House of Representatives are pushing a major tax reform package that would change the way corporations are taxed. Instead of being based on where goods are produced, the tax would be applied on the basis of where goods end up. The tax would also involve a border adjustment, meaning that it would not be imposed on U.S. exports (which are taxed in other countries) but it would apply to all imports. In essence, the tax burden would shift from goods produced in the United States to goods consumed in the United States.

Such measures are standard practice for countries that have value-added taxes and wish to equalize the tax treatment between domestic and foreign goods, and they are consistent with WTO rules. Whether the particular border adjustment tax that Congress is considering now conforms to WTO rules remains an open question. Still, the principle remains: a border adjustment tax is not protectionist if it does not discriminate in favor of U.S. producers and instead simply ensures that the same tax is imposed on all sellers in the U.S. market, regardless of where their goods are produced.

THE FUTURE OF FREE TRADE

Trump's "America first" trade rhetoric has sparked fears in foreign capitals of a coming trade war. Economists of all political stripes remain deeply skeptical that the protectionist measures the president discussed during the campaign will spur a renaissance of manufacturing production or do much to boost employment.

Yet Trump's pronouncements on trade are not just economically problematic; they also raise troubling questions about the United States' place in the world. A turn inward would mean abandoning global leadership, threatening the country's economic and political interests.

Already, the abrupt termination of the TPP has stoked fears of a U.S. retreat from Asia. Trump's saber rattling with Mexico has led to a growing anti-American backlash there. Just consider what happened in Canada after the United States imposed the Smoot-Hawley Tariff. The pro-American, pro-free-trade Liberal government lost power to the protectionist Conservative Party, which promptly retaliated against U.S. exports. In Mexico, the last thing the United States needs is to inadvertently give rise to an anti-American president who returns to economic nationalism and seeks common cause with leftist governments in Cuba and Venezuela.

There is a charitable view of Trump's threats to impose trade barriers, however: that they represent a negotiating tactic to seek new agreements that would scale back other countries' distorting policies. In a January interview with *The New York Times*, Trump called himself "a free trader" but added, "It's got to be reasonably fair." Likewise, the administration has announced that it wants to replace the TPP with a series of bilateral agreements, although it's not clear why a dozen bilateral agreements would prove superior to one regional agreement.

Unfortunately, most of what Trump has said to date suggests that he is interested in protectionism for protectionism's sake. He seems to view international trade as a zero-sum game, in which one country wins and another loses, with the trade balance being the scorecard. "We will follow two simple rules: Buy American and hire American," he said in his inaugural address. But if every country adopted a similar pledge, international trade would shrivel up.

Lessons from the past, such as the trade disaster of the 1930s, suggest that protectionism begets protectionism. Indeed, a poll released in February found that 58 percent of Canadians want their government to fight a trade war if the United States imposes tariffs on Canadian goods. History also reveals that trade barriers are easy to impose and hard to remove. And it can take decades to repair the damage. 🌐