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ACTIVE LEARNING CASE

US–China trade war: battle of the giants

A decade on from 2008's financial crisis, another major challenge to international trade and multinational firms occurred, in the form of a trade war between the US and China. The origins behind the trade war can be traced back to 2014, before Donald Trump was elected as US President and even before he started his presidential campaign, to Trump's demands for a crackdown on China's trade policies with the US. Trump's threats against China started to gain momentum during his political campaign in 2016 where he asserted, '[the US] can't continue to allow China to rape our country, and that's what they're doing'. In 2017, the first year of Trump's presidency, the US officially announced that they were launching an investigation into Chinese trade policies, with a heavy emphasis on intellectual property. The US justified this investigation by stating that counterfeit goods, pirated software and the theft of US trade secrets by China cost the American economy approximately $600 billion (£470 billion) a year.

A thaw in relations appeared in mid-2017, as the relationship between Trump and Xi Jinping, President of China, appeared amicable and both parties quickly resolved a trade deal concerning a sub-set of traded products including beef and poultry. But by 2018, the world's two largest economies went aggressively head-to-head with a series of additional tariffs and new trade barriers. Tariffs act as protectionist trade barriers by imposing additional costs on imported products, making domestic products cheaper or more cost-competitive by comparison. The US government was eager to impose tariffs to simply encourage US consumers to buy more American goods. However, this trade war created a turbulent political arena for nations trading all over the world: today's global integrated economy means that a battle between the largest economies have a significant ripple effect, a lesson undoubtedly learnt from the 2008 economic meltdown.

Table 6.1 maps out the key moves and counter-moves on both sides after the US imposed its first tariff, on a particular range of washing machines and solar cells. This was a clear attempt to provide firms like Whirlpool, an American MNE that manufactures home appliances, an advantage over the Chinese conglomerate Haier. The tariff consisted of a 20 per cent tariff on the first 1.2 million imported washers in the first year and a 50 per cent tariff on subsequent imports. The tariffs were set to reduce to 16 per cent for the first 1.2 million washing machines and 40 per cent on above 1.2 million washing machines in the third year. However, this move did not only impact China, but also punished South Korea who supply a large quantity of washing machines to the US under flagship brands such as Samsung and LG. With regard to solar cells, the US declared that a 30 per cent tariff was to be imposed in year one and that this would gradually decrease to a tariff of 15 per cent by year 4, but this measure did allow for 2.5 gigawatts of unassembled solar cells per year to be imported with no tariffs.

Table 6.1 The 2018 US–China Trade War: ten key events

US	2018	China
1. Tariff of 20%–50% on washing machines and tariff of 30% on solar panels	January	
2. Tariff of 25% on steel and tariff of 10% on aluminium	February	
	March	
	April	3. Tariffs accounting for $3 billion in goods from US
4. Negotiations between US and China representatives fail to end trade war	May	4. Negotiations between US and China representatives fail to end trade war
5. Tariffs accounting for $50 billion in goods from China	June	6. Tariffs accounting for $50 billion in goods from US
	July	
	August	
7. Tariffs accounting for $200 billion in goods from China	September	8. Tariffs accounting for $60 billion in goods from US
	October	
9. Trade negotiations between Trump and Xi begin	November	9. Trade negotiations between Trump and Xi begin
10. Trump and Xi meet at G-20 summit	December	10. Trump and Xi meet at G-20 summit
Several rounds of tariffs on China totalling more than $250 billion.		Several rounds of retaliation tariffs on the US totalling more than $130 billion.

In February, Trump continued his initial attack by imposing worldwide import tariffs of 25 per cent and 10 per cent on aluminium and steel respectively. Although China was the US's prime target, the fact that this was a globally imposed tariff meant that many countries and trading groups were quick to retaliate. For instance, the EU stated that the tariffs were unfair and extremely protectionist, and in turn they revealed plans to place tariffs on certain products from the US, namely: orange juice; denim; motorbikes and peanuts. In addition, neighbouring countries Mexico and Canada were quick to hit back with their own levies on US imports. For instance, Mexico placed tariffs on pork bellies, apples, grapes, cheeses and flat steel. Although Mexico certainly exports more to the US than it imports, Mexico was the second largest market for US exports, having purchased $277 billion worth of US products and services in 2017. Importantly, the intention behind Trump's tariffs was to protect US jobs, but these tariffs were hurting the US economy too as approximately 110,000 US jobs are directly tied to US pork exports to Mexico and other countries. Meanwhile, Canada placed duties on $12.8 billion worth of US goods. By way of a contrast, in exchange for being spared the costs of tariffs set on steel, Brazil, Argentina and Australia all agreed that they would limit the quantity of steel shipments to the US. At this point in time the US also asserted that all tariffs were to remain on Japanese imports.

April 2018 marked the first of China's retaliations to US's trade restrictions, but its approach was more measured, restricting 128 US products that totalled an import value of only $3 billion, far lower than Trump's Chinese tariffs, which were thought to be valued at $60 billion. Moreover, US goods that were exported to China were worth around $115.6 billion in 2017, so Beijing's small focus on just $3 billion of US imports was a cautious move; they did not want escalate the situation and prompt further retaliation from the US. China tends to assert that it is a nation that champions global trade but it is important to note that it has strong protectionist measures in place affecting particular industry sectors. Foreign companies, for example, have limited access to certain markets and oblige foreign investors to form partnerships with Chinese firms in areas like aviation, information and communications technology (ICT) sectors and banking. Foreign firms are compelled to share their technological know-how, often resulting in counterfeit products, in exchange for market access. China's relatively small strike on the US was perhaps a strategic decision designed to show the world that they were a trade globalist and to distance themselves from the heavily protectionist stance taken by the US.

Representatives from the US and China met in May in a bid to reach some middle ground, but this meeting ultimately failed to end the trade war. June was an important month as this was the first time Xi Jinping decided to impose equivalent tariffs on the US. For instance, after May's deliberations, Trump announced a 25 per cent tariff on other Chinese products, valued at $50 billion worth of Chinese goods. China responded immediately by implementing tariffs valued at $50 billion of American goods.

The US responded again later that summer, imposing tariffs worth $200 billion on Chinese goods, representing a staggering four times the value of the previous attack in June. These new tariffs meant that 40 per cent of all Chinese goods sold to the US were now impacted. Given this, US consumers would inevitably witness a rise in price for goods such as, but not limited to, handbags, furniture, bicycle tyres and air-conditioning units. The new tariffs would start at 10 per cent during the end of September 2018 and rise to 25 per cent the following year. Trump also stepped up the level of aggression by asserting that if Xi were to retaliate, then he would seek to deliver the knockout punch ending this trade war by immediately increasing extra tariffs worth $267 billion of Chinese imports. If this did occur, it would have meant that all goods imported to the US from China would be subjected to tariffs. However, Xi was quick to retaliate and Beijing declared that they were going to implement tariffs of their own on US goods including small aircraft, computers, textiles, chemicals, meat, wheat and wine. Although, again, these tariffs would only account for around $60 billion – just a quarter of the amount imposed by the US.

Closely following this exchange of blows, many US firms started to voice their concerns. 3M, a global consumer-goods manufacturer, suggested that overall tariffs on China's imports was ultimately having a negative impact on their total sourcing costs. More specifically, Nick Gangestad, 3M's Chief Financial Officer, highlighted that the tariffs would leave the firm with approximately $100 million in headwind to deal with. Tesla also reported that the new tariffs would cost the firm $50 million in the fourth quarter of 2018 alone and Harley-Davidson reported costs of around $43–$48 million for the same time period. Ford then joined in, stating that aluminium and steel tariffs set at the start of 2018 had cost the automotive giant approximately $1 billion, despite sourcing the majority of their metal components from the US.

The circular nature of the global economy, with large interdependencies between US firms and Chinese suppliers, as well as large numbers of US businesses reliant on China's growing market to maintain their own revenues, began to create a backlash against these protectionist policies. Trump did not impose any further heavy tariffs against China for the rest of 2018. Trump and Xi restarted their negotiations in November, finally meeting each other face-to-face at the G-20 summit in December. The trade negotiations continued into 2019 with few tangible outcomes. If tariffs against China are not lifted by the US, then the future appears challenging for MNEs and it would not be surprising if such firms decide to re-locate certain operations to overcome current restrictions. For instance, during the start of 2019 Apple announced they would be shifting the production of their high-end iPhones

from China to India, and although this is inevitably a costly and risky move, the firm stated that they believe this is a risk they need to take to avoid being caught in the crossfire between the US and China.

The US and China trade war is the largest of its kind in economic history. After several rounds of tariffs, the US imposed tariffs on $250 billion worth of goods from China, with threats of increasing this to over $500 billion. In contrast, China's tariffs on US goods totalled approximately $130 billion, and while these are still sizable, they are relatively modest in comparison with the US's actions. In January 2019, the World Bank issued a warning stating that the impact of the US and China trade war is likely to have global repercussions over the next few years. More specifically, they speculate that a global recession is likely to occur by 2020, as the global integrated economy is predicted to slow to 2.9 per cent by the end of 2019, compared with 3 per cent in 2018. For the global knock-on effects of trade wars to be minimised, political leaders like Trump and Xi need to quickly focus on economic compromise in place of political brinkmanship.

Sources: https://www.cnbc.com/2018/11/30/timeline-of-us-china-tradewar-as-trump-and-xi-meet-at-g-20-in-argentina.html; https://www.iol.co.za/business-report/economy/world-bank-issues-stark-warning-on-us-china-tradewar-impact-18757982; https://www.theguardian.com/environment/2018/jan/23/trump-imposes-steep-tariffs-on-imported-solar-panels-and-washing-machines; https://www.nbcnews.com/news/us-news/trump-team-advocates-burning-fossil-fuels-even-u-s-scientists-n946826; https://news.sky.com/story/trumps-tariffs-what-you-need-to-know-11391050; https://money.cnn.com/2018/06/06/news/economy/mexico-us-tariffs-retaliation/index.html; https://www.bbc.co.uk/news/business-45899310; https://www.telegraph.co.uk/business/2018/09/17/donald-trump-announces-tariffs-200-billion-chinese-goods/; https://www.businessinsider.com/trump-tariffs-china-tradewar-us-companies-prices-2018-10?r=US&IR=T; https://www.forbes.com/sites/davidvolodzko/2019/01/17/will-apple-become-the-tradewars-next-victim/#75a51a3e3617.

1. **How do trade wars work against the principles supported by the theory of comparative advantage?**
2. **What reasons were given for the start and subsequent escalation of the US–China trade war in 2017–18?**
3. **How can trade barriers negatively affect third countries who are not directly targeted in a trade war?**

INTRODUCTION

International trade is the branch of economics concerned with the exchange of goods and services with foreign countries. Although this is a complex subject, we will focus on two particular areas: international trade theory and barriers to trade.

Some international economic problems cannot be solved in the short run. Consider the US balance of trade deficit. US trade with Japan and China heavily affects its overall imbalance. Moreover, this trade deficit will not be reduced by political measures alone; it will require long-run economic measures that reduce imports and increase exports. Other nations are also learning this lesson – and not just those that have negative balances. After all, most countries seem to want a continual favourable trade balance, although this is impossible, since a nation with a deficit must be matched by a nation with a surplus.[1]

The complexity of global value chains, in services and manufacturing, make international trade an even more important topic today. Currency shifts, inflation and, in many cases, unemployment present critical challenges alongside trade interdependencies across countries. However, there is strong evidence that open trade brings growth and prosperity to the world economic system. Since the time of Adam Smith in 1790, economists have shown that free trade is efficient and leads to maximum economic welfare. More recently, new trade theory and its variants have suggested that governments intervene in markets 'intelligently' to enhance the benefits of international trade. In this chapter we will discuss the economic rationale for free trade, the political impediments to it and some newer interpretations of how trade policy should be managed.

INTERNATIONAL TRADE THEORY

To understand the topic of international trade, we must be able to answer the question: why do nations trade? One of the earliest and simplest answers to this question was provided by **mercantilism**, a theory that was quite popular in the eighteenth century, when gold was the only world currency. Mercantilism holds that a government can improve the economic well-being of the country by encouraging exports and stifling imports. The result is a positive balance of trade that leads to wealth (gold) flowing into the country.

Mercantilism
A trade theory which holds that a government can improve the economic well-being of the country by encouraging exports and stifling imports to accumulate wealth in the form of precious metals

Neo-mercantilism, like mercantilism, seeks to produce a positive balance of trade but without the reliance on precious metals. Most international trade experts believe that mercantilism is a simplistic and erroneous theory, although it has had followers. For example, under President Mitterrand in the late 1970s and early 1980s, France sought to revitalise its industrial base by nationalising key industries and banks and subsidising exports over imports. By the mid-1980s the French government realised that the strategy was not working and began denationalising many of its holdings.[2] More recently, China has proven to be a strong adherent of mercantilism, as reflected by the fact that it tries to have a positive balance with all of its trading partners.

Neo-mercantilism
A trade theory which holds that a government can improve the economic well-being of the country by encouraging exports and stifling imports

A more useful explanation of why nations trade is provided by trade theories that focus on specialisation of effort. The theories of absolute and comparative advantage are good examples.

Theory of absolute advantage

The **theory of absolute advantage** holds that nations can increase their economic well-being by specialising in the production of goods they can produce more efficiently than anyone else. A simple example can illustrate this point. Assume that two nations, North and South, are both able to produce two goods, cloth and grain. Assume further that labour is the only scarce factor of production and thus the only cost.

Theory of absolute advantage
A trade theory which holds that nations can increase their economic well-being by specialising in goods that they can produce more efficiently than anyone else

Labour cost (hours) of production for 1 unit

	Cloth	Grain
North	10	20
South	20	10

Thus lower labour-hours per unit of production mean lower production costs and higher productivity per labour-hour. As seen by the data in the table, North has an absolute advantage in the production of cloth since the cost requires only 10 labour-hours, compared to 20 labour-hours in South. Similarly, South has an absolute advantage in the production of grain, which it produces at a cost of 10 labour-hours, compared to 20 labour-hours in North.

Both countries gain by trade. If they specialise and exchange cloth for grain at a relative price of 1:1, each country can employ its resources to produce a greater amount of goods. North can import 1 unit of grain in exchange for 1 unit of cloth, thereby paying only 10 labour-hours for 1 unit of grain. If North had produced the grain itself, it would have used 20 labour-hours per unit, so North gains 10 labour-hours from the trade. In the same way, South gains from trade when it imports 1 unit of cloth in exchange for 1 unit of grain. The effective cost to South for 1 unit of cloth is only the 10 labour-hours required to make its 1 unit of grain.

The theory of absolute advantage, as originally formulated, does not predict the exchange ratio between cloth and grain once trade is opened, nor does it resolve the division of the

gains from trade between the two countries. Our example assumed an international price ratio of 1:1, but this ratio (P_{cloth} to P_{grain}) could lie between 2:1 (the pre-trade price ratio in South) and 1:2 (the pre-trade price ratio in North). To determine the relative price ratio under trade, we would have to know the total resources of each country (total labour-hours available per year), and the demand of each for both cloth and grain. In this way we could determine the relative gains from trade for each country.

Even this simple model of absolute advantage has several important implications for international trade. First, if a country has an absolute advantage in producing a product, it has the potential to gain from trade. Second, the more a country is able to specialise in the good it produces most efficiently, the greater its potential gains in national well-being. Third, the competitive market does not evenly distribute the gains from trade *within* one country. This last implication is illustrated by the following example.

Prior to trade, the grain farmers in North work 20 hours to produce 1 unit of grain that could be exchanged for 2 units of cloth. After trade, those who remain can exchange 1 unit of grain for only 1 unit of cloth. Thus, the remaining grain producers are worse off under trade. Cloth producers in North, however, work 10 hours, produce 1 unit of cloth, and exchange it for 1 unit of grain, whereas previously they received only half a unit of grain. They are better off. If grain producers in North switch to cloth production, then 20 hours of labour results in the production of 2 units of cloth, which they can exchange for 2 units of grain. Thus, international trade helps them. As long as North does not specialise completely in cloth, there will be gainers (cloth producers and grain producers who switched to cloth) and losers (those who continue as grain producers).

Because the nation as a whole benefits from trade, the gainers can compensate the losers and there will still be a surplus to be distributed in some way. If such compensation does not take place, however, the losers (continuing grain producers) will have an incentive to try to prevent the country from opening itself up to trade. Historically, this problem has continued to fuel opposition to a free trade policy that reduces barriers to trade. A good example is Japanese farmers who stand to lose their livelihood if the government opens up Japan to lower-priced agricultural imports.

A more complicated picture of the determinants and effects of trade emerges when one of the trading partners has an absolute advantage in the production of both goods. However, trade under these conditions still brings gains, as David Ricardo first demonstrated in his theory of comparative advantage.

Theory of comparative advantage

Theory of comparative advantage
A trade theory which holds that nations should produce those goods for which they have the greatest relative advantage

The **theory of comparative advantage** holds that nations should produce those goods for which they have the greatest relative advantage. In terms of the previous example of two countries, North and South, and two commodities, cloth and grain, Ricardo's model can be illustrated as follows:

Labour cost (hours) of production for 1 unit

	Cloth	Grain
North	50	100
South	200	200

In this example North has an absolute advantage in the production of *both* cloth and grain, so it would appear at first sight that trade would be unprofitable, or at least that incentives for exchange no longer exist. Yet trade is still advantageous to both nations, provided their *relative* costs of production differ.

Before trade, 1 unit of cloth in North costs (50/100) hours of grain, so 1 unit of cloth can be exchanged for half a unit of grain. The price of cloth is half the price of grain. In South, 1 unit of cloth costs (200/200) hours of grain, or 1 grain unit. The price of cloth equals the price of grain. If North can import more than half a unit of grain for 1 unit of cloth, it will gain from trade. Similarly, if South can import 1 unit of cloth for less than 1 unit of grain, it will also gain from trade. These relative price ratios set the boundaries for trade. Trade is profitable between price ratios (price of cloth to price of grain) of 0.5 and 1. For example, at an international price ratio of two-thirds, North gains. It can import 1 unit of grain in return for exporting 1.5 units of cloth. Because it costs only 50 hours of labour to produce a unit of cloth, its effective cost under trade for 1 unit of imported grain is 75 labour-hours. Under pre-trade conditions it costs North 100 labour-hours to produce 1 unit of grain. Similarly, South gains from trade by importing 1 unit of cloth in exchange for two-thirds of a unit of grain. Prior to trade, South spent 200 labour-hours producing the 1 unit of cloth. Through trade, its effective cost for 1 unit of cloth is $\frac{2}{3} \times 200$, or 133 labour-hours – cheaper than the domestic production cost of 200 labour-hours. Assuming free trade between the two nations, North will tend to specialise in the production of cloth, and South will tend to specialise in the production of grain.

This example illustrates a general principle. There are gains from trade whenever the relative price ratios of two goods differ under international exchange from what they would be under conditions of no trade. Such domestic conditions are often referred to as *autarky*, which is a government policy of being totally self-sufficient. Research shows that free trade is superior to autarky. In particular, free trade provides greater economic output and consumption to the trade partners jointly than they can achieve by working alone. By specialising in the production of certain goods, exporting those products for which they have a comparative advantage, and importing those for which they have a comparative disadvantage, the countries end up being better off.

The general conclusions of the theory of comparative advantage are the same as those for the theory of absolute advantage. In addition, the theory of comparative advantage demonstrates that countries jointly benefit from free trade (under the assumptions of the model) even if one has an absolute advantage in the production of *both* goods. Total world efficiency and consumption increase.

As with the theory of absolute advantage discussed previously, Ricardo's theory of comparative advantage does not answer the question of the distribution of gains between the two countries, or the distribution of gains and losses between grain producers and cloth producers within each country. No country will lose under free trade, but in theory at least, all the gains could accrue to one country and to only one group within that country.

✔ Active learning check

Review your answer to Active Learning Case question 1 and make any changes you like. Then compare your answer to the one below.

1 How do trade wars work against the principles supported by the theory of comparative advantage?

The theory of comparative advantage holds that nations should produce those goods and services for which they have the greatest relative advantage. By doing so, both countries prosper through exchange; their economic growth and the resulting wealth created, is greater than if they did not trade. Trade wars involve adding costs through tariff and non-tariff barriers, which reduce natural comparative advantages and reduce the incentives to trade. Both parties are worse-off economically as a result.