

Why Start a Trade War with China?

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Introduction

In April 2018, the United States announced tariffs on \$50 billion of Chinese goods¹, inciting a trade war between the two nations. Retaliations resulted in Chinese tariffs on \$138 billion of U.S. goods and U.S. tariffs on \$400 billion on Chinese goods through September 2019². The consequences: an estimated 300,000 American jobs lost³ and an average cost of \$600-832/year for each American household⁴. So, why start this trade war with China?

First, let's take a look at the parties responsible for making this decision. The office of the United States Trade Representative (USTR) implements U.S. Trade Policy⁵. It is led by Robert Lighthizer, the current Trade Representative appointed by President Donald Trump. He sits with the National Economic Council (NEC) to make high-level trade policy decisions⁶. At the start of the trade war, these were the members of the consortium of decision makers:

National Economic Council (NEC)	
NEC – Director	Larry Kudlow
NEC – Deputy Director	Clete Williams
U.S. – President	Donald Trump
U.S. – Vice President	Mike Pence
USTR – Trade Representative	Robert Lighthizer
Agriculture Department – Secretary	Sonny Perdue
Commerce Department – Secretary	Wilbur L. Ross, Jr.
Council of Economic Advisors – Chair	Kevin Hassett
Domestic Policy Council – Director	Brooke Rollins
Energy Department – Secretary	Dan Brouillette
Environmental Protection Agency – Secretary	Andrew R. Wheeler
Health and Human Services – Secretary	Alex Azar
Housing and Urban Development Department – Secretary	Ben Carson
Labor Department – Secretary	Eugene Scalia

National Security Advisor	H.R. McMaster
Office of Management and Budget – Director	Mick Mulvaney
Office of Trade and Manufacturing Policy - Director	Peter Navarro
State Department – Secretary	Mike Pompeo
Transportation Department – Secretary	Elaine Chao
Treasury Department – Secretary	Steven Mnuchin

Objectives of each of these members and other key trade agencies can be found [here](#). A full discussion on the competing interests of these parties and their influences on the decision to start a trade war is beyond the scope of this paper. Instead, I will focus on the few members who have been outspoken advocates for tariffs: Wilbur L. Ross, Jr. and Peter Navarro.

Correcting Trade Imbalances

President Trump has been a strong proponent of tariffs, calling himself a “Tariff Man” in a 2018 tweet⁷. One of his primary objectives in using tariffs is to reduce the trade imbalance the United States has with other countries⁸. In large part to assist him with this goal, he created the Office of Trade and Manufacturing Policy⁹, appointing Peter Navarro as its first director. He also appointed Wilbur L. Ross, Jr. to his cabinet, serving as Secretary of the Commerce Department. Navarro¹⁰ and Ross¹¹ have both been vocal advocates of using tariffs to reduce the trade deficit.

What is a trade deficit? The U.S. trade deficit is a negative trade balance held with another country. A trade balance is measured by subtracting imports from exports. U.S. trade deficit with China hit an all-time high in 2018 with Chinese imports to the U.S. exceeding U.S. exports to China by \$419.2 billion¹². In 2019, the U.S. trade deficit with China was \$345.6 billion, making up half of the total trade deficit the U.S. had with its top five trading partners¹³. Navarro and Ross argue the trade deficit is bad for the economy.

Navarro wrote in the New York Times in 2018:

American tariffs are among the lowest in the world. Our generosity and free market good will has only led to a huge trade deficit and the transfer of wealth abroad¹⁰.

Ross's opening lines his first day in office took a similar tack:

The United States is the least protectionist country in the world but has the largest trade deficit, while other countries are highly protectionist and have huge trade surpluses. This cannot continue.

We can no longer afford to be ignorant or naive in the aggressive global marketplace, and there is no reason why we should be forced to singlehandedly absorb the \$500 billion trade surplus of the rest of the world¹¹.

These statements imply a negative effect of trade deficits. But if this theory is correct, supposedly reducing the trade deficit would have helped the American economy, but estimates say the trade war has harmed it.

A survey of economists conducted by the Chicago Booth school of economics showed strong disagreement with the idea that reducing trade deficits would improve citizens' welfare¹⁴. Another such survey found unanimous agreement that U.S. tariffs on steel and aluminum would *not* improve Americans' welfare¹⁵. Other economists have likewise been critical of the administration's trade theory^{16,17}. The late Nobel Laureate economist Milton Friedman explained why trade deficits are not bad for a country's economy:

In the international trade area, the language is almost always about how we must export, and what's really good is an industry that produces exports, and if we buy from abroad and import, that's bad. But surely that's upside-down.

What we send abroad, we can't eat, we can't wear, we can't use for our houses. The goods and services we send abroad, are goods and services not available to us. On the other hand, the goods and services we import, they provide us with TV sets we can watch, with automobiles we can drive, with all sorts of nice things for us to use.

The gain from foreign trade is what we import. What we export is a cost of getting those imports. And the proper objective for a nation as Adam Smith put it, is to arrange things so that we get as large a volume of imports as possible, for as small a volume of exports as possible¹⁸.

Friedman's defense of trade deficits could also lead us to a better understanding of the administration's motivations for reducing them: benefits to tariffs are more visible than their costs. The gains Friedman referred to in the previous quote are divided among many people while the group of workers who lose is much smaller. Friedman argues even producers lose from tariffs:

Even for the productive side of our lives, the visible effects of tariffs are good, the invisible effects of tariffs are bad.... I have already referred to the steel case. It's perfectly clear that if you restrict the imports of steel, there are some workers in the steel industry who will have jobs they otherwise would not

have. The beneficial effects for them of a tariff is perfectly clear. But, if we import less steel, foreigners earn fewer dollars. They have fewer dollars to spend in this country. There are people around the country who will not have ... productive jobs because exports do not develop... as a result: on both the side of consumption and the side of producers, you have a concentrated special interest versus the diffused general interest¹⁹.

Proponents of decreasing trade deficits may be mistaken by overlooking the “invisible effects of tariffs”. But there are other potential justifications for increasing domestic production of certain goods.

Another Take – National Security

There was a time when economists were more concerned with trade imbalances. In 1948, editor of *The Economist*, Geoffrey Crowther warned chaos would result from failure to correct trade deficits and surpluses²⁰. In 1944, John Maynard Keynes, author of one of the major macroeconomic schools of thought, proposed a plan for an International Clearing Union that would fix exchange rates between nations and provide incentives powerful enough to bring nations with trade imbalances to a trade balance²¹. He argued in 1933 that National Self-Sufficiency would insulate a country from the negative impacts of downturns that occur in foreign economies:

most modern processes of mass production can be performed in most countries and climates with almost equal efficiency... we all need to be as free as possible of interference from economic changes elsewhere, in order to

make our own favorite experiments towards the ideal social republic of the future; and that a deliberate movement towards greater national self-sufficiency and economic isolation will make our task easier, in so far as it can be accomplished without excessive economic cost²².

Peter Navarro has taken up a very similar line of thought in his defense of tariffs:

President Trump reserves the right to defend those industries critical to our own national security. To do this, the United States has imposed tariffs on aluminum and steel imports. While critics may question how these metal tariffs can be imposed in the name of national security on allies and neighbors like Canada, they miss the fundamental point: These tariffs are not aimed at any one country. They are a defensive measure to ensure the domestic viability of two of the most important industries necessary for United States military and civilian production at times of crisis so that the United States can defend itself as well as its allies¹⁰.

One rebuttal of this national security argument is that “the United States already produces more than two thirds of its own steel²⁰.” It seems the administration would receive less criticism from economists if they focused on strengthening the national security argument instead of continually claiming trade deficits are bad for the U.S. economy. But there is one more reason to impose tariffs on China and it may be the strongest of all.

Intellectual Property Theft and Unfair Technology Transfers

In 2018, the USTR published a document outlining the findings of its investigation into China's unfair trade policies. In it the authors specify that "Concerns about a wide range of unfair practices of the Chinese government (and the Chinese Communist Party (CCP)) related to technology transfer, intellectual property, and innovation are longstanding²¹." The unfair practices include:

1. Use of pressure on US companies to transfer technology to Chinese companies as a cost of doing business with them
2. Unfair licensing agreements that limit the control US companies have over their own technology when used in China
3. Unfair acquisition of US companies to facilitate large-scale technology transfer to the Chinese government
4. Use of cyber methods to steal US intellectual property

China has agreed at least eight times to end such unfair practices, but the behavior continues. U.S. companies are wary to report unfair trade practices because they fear retaliation from China. China's practice of intellectual property acquisition from foreign government is part of its strategy to become a competitive force in the global technology and innovation market and to become technologically self-sufficient.

These practices are estimated to cost the United States between \$225 billion and \$600 billion annually. From the same document, "A report by the Center for Strategic and International Studies (CSIS) and McAfee, found that cybercrime from all sources costs

approximately 200,000 jobs annually in the United States²¹.” A comparable figure to the estimated *total* number of jobs lost from the trade war.

The USTR recommended using a range of tools “to address these serious matters including more intensive bilateral engagement, WTO dispute settlement, and/or additional Section 301 investigations²¹.” Available tools include (from the same document)²¹:

- i. *suspending, withdrawing or preventing the application of benefits of trade agreement concessions*
- ii. *imposing duties, fees, or other import restrictions on the goods or services of the foreign country for such time as deemed appropriate*
- iii. *withdrawing or suspending preferential duty treatment under a preference program*
- iv. *entering into binding agreements that commit the foreign country to eliminate or phase out the offending conduct or to provide compensatory trade benefits*
- v. *restricting or denying the issuance of service sector authorizations, which are federal permits or other authorizations needed to supply services in some sectors in the United States*
- vi. *taking any actions that are within the President’s power with respect to trade in goods or services, or with respect to any other area of pertinent relations with the foreign country*

President Trump’s decision to implement the second tool began the U.S. - China trade war. Were the tariffs successful? Before answering that question, we need to use Decision Science to clarify what we mean by “success”.

Decision Science Analysis – Essential and Instrumental Values

A little introduction before we start labeling motivations as essential or instrumental:

During the Iraq war, U.S. generals were criticized for not counting deaths of Iraqi civilians. To many it was a dishonor to the deceased to not count every death. But to others, the death counts were gathered primarily to assist in conducting a successful war effort²². Dr. Baruch Fischhoff classifies the first of these motivations as *essential* and the second as *instrumental*, giving additional examples in the following excerpt:

The adequacy of casualty records depends on how they are used. Their purpose can be essential or instrumental. If the purpose is essential, then the information has inherent value. For example, recording victims' sex would partially satisfy the desire to dignify every death by knowing as much as possible about the victim. It would be especially important for a society with different death rituals for women and men. If the purpose is instrumental, the information is a means to an end. That end might be practical, such as determining criminal charges (e.g., victims' sex matters, if penalties differ for killing men and women). Or it might be scientific, such as understanding a regime's intimidation practices (e.g., victims' sex matters, if it clarifies how they are selected)²².

Those in the consortium of decision makers that agreed upon imposing tariffs on Chinese goods had both essential and instrumental motivations. For some the goal was the tariff itself, for others it was changing China's behavior.

- **Essential Motivations:**
 - Imposing tariffs will improve the U.S. Economy
 - Imposing tariffs is in the best interest of U.S. national security
- **Instrumental Motivation:**
 - Putting an end to China's unfair technology transfer schemes

Before measuring the success of the tariffs, we must identify which objective the tariff had. For at least one objective, the results are clear: imposing tariffs *hurt* the American economy. President Trump, Navarro, and Ross should stop insisting that tariffs are beneficial to the economy. They could shift attention to the goal of national security. Hardly any debate has focused on it. Success of the instrumental objective will take some discussion.

Changing China's Behavior

On January 15, 2020, China entered "Phase One" of a trade agreement with the United States²³. According to the prominent law firm, Covington, this agreement served to "halt the escalation of the trade war, including averting the imposition of tariffs on \$160 billion in Chinese goods, which would have substantially included consumer goods for the first time²⁴."

In the deal, China promises to make changes to stop unfair technology transfer. Bloomberg reports:

The deal states China must apply criminal penalties on anyone caught stealing commercial secrets and do more to stop the sale of pirated goods online, as well as fake pharmaceutical products. It also requires Beijing to deliver an

action plan within 30 days of the deal taking effect on how it intends to meet its commitments on intellectual property.

Separately, it includes a broad commitment for China to stop pressuring American companies investing in the country to share technology with local joint-venture partners and for the government to stop supporting or directing Chinese firms to buy up strategic technologies by acquiring foreign companies.

Both have been chief complaints of the U.S., which has curbed inbound investments from China, particularly in the tech sector²⁵.

But the success of the tariffs really depended upon the subsequent phases of the trade deal. In the same article, Bloomberg further reports:

But the new pact has already been criticized for what is missing. It does nothing to address areas like what U.S. authorities have long claimed is China's state-backed hacking of American companies and government institutions. Nor does it require the Asian power to reform the vast web of state subsidies that form the spine of its model of state capitalism and have helped fuel the rapid growth of Chinese companies internationally.

The administration says many of those issues will be covered in a second phase of a deal, though when those talks will begin and how long they will take remains uncertain. In the meantime, the U.S. is also set to maintain tariffs on roughly two-thirds of imports from China, something that Trump on

Wednesday said was essential as leverage over the country until it agreed to further reforms²⁵.

Unfortunately, because of the Coronavirus pandemic, U.S. - China relations deteriorated, and Phase Two talks never began. When asked about Phase Two in July of 2020, President Trump responded, “I don’t think about that. The relationship with China has been severely damaged²⁶.” But, president-elect Biden does not plan on removing the tariffs as he takes office²⁷, so we may yet learn whether the tariffs will persuade China to change its behavior.

Conclusion

Imposing tariffs on Chinese imports was a decision complicated by the varying essential and instrumental motivations underlying it. One of the essential motivations – believing tariffs benefit the U.S. economy – was misguided. Another essential motivation – securing America’s national interests – was mostly overlooked by proponents and critics of tariffs. The most universally agreed upon motivation for the tariffs was the instrumental one – getting China to stop unfair trade practices related to technology transfer. It is unclear if tariffs will have that desired impact.

To make optimal trade decisions in the future, decision makers should focus on the instrumental value of tariffs. The essential motivation may lead to applying tariffs with too heavy a hand and cause unnecessary disagreement among consortium members.

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