

Globalism at a Crossroads: Rising Protectionism & What It Means for East Asia

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Introduction

The year 2016 should go down in history as a crossroads for globalism. In its national referendum in June, the United Kingdom decided to withdraw from the European Union, while the US presidential election in November gave victory to Donald Trump, who had pushed anti-globalization policies to the forefront with opposition to free trade and immigration. On Jan. 23, 2017, just three days after his inauguration, President Trump signed a presidential decree announcing the irrevocable withdrawal from the Trans-Pacific Partnership (TPP), and it is reported that in late June official consultations with Mexico and Canada will be launched towards the renegotiation of the North America Free Trade Agreement (NAFTA). The global rise of protectionism is a matter for serious concern regarding sustained growth for the countries of East Asia, which have been generating growth through trade and investment liberalization and regional integration. The US withdrawal from the TPP in particular demands a fundamental rethinking of growth strategies by Japan, which has expended massive political capital in seeking to achieve a high level of liberalization in all of East Asia, and by Malaysia and Vietnam, which have decided to embark on drastic domestic reforms in exchange for access to the US market.

In this essay, we will review some important work on the impact of trade liberalization on regional labor markets, focusing mainly on China, in exploring (1) the background to the rise of US protectionism, (2) the potential for rising protectionism in East Asia, and (3) what is necessary to promote free trade in East Asia going forward.

Background to Protectionism in the US

Outbreak of the China Syndrome

There has been a growing body of empirical research in the United States in recent years on the effect of free trade on the domestic regional labor markets. As a result of a series of studies, the conclusion that imports from China caused the deterioration of US manufacturing and the economy of the Rust Belt (the Midwest and Northeast regions) has received a certain level of support.

“The China Syndrome: Local Labor Market Effects of Import Competition in the United States” (*American Economic Review*, 103(6), pp. 2121-68, 2013) by D. H. Autor, D. Horn and G. H. Hanson is a pioneering study on this subject. The authors assume for the

purposes of the study that the rapid rise in imports from China is the result of exogenous factors on the Chinese side such as rising productivity due to China’s transition to a market economy and its accession to the World Trade Organization (WTO). (This does mean that endogenous factors such as growing US demand are ignored.) They analyze the relationship between the rise of imports from China and wages and labor participation rates between 1990 and 2007 through two-stage least squares (2SLS) regression analysis.

The results of this research suggest that regions where industries competing with imports from China are concentrated saw wages and labor participation rates affected negatively, the average household income in that region was reduced, and social welfare expenditures rose. However, a calculation of the increase in the transfer benefits payments broken down by program demonstrates that the one that showed the largest transfer increase was medical benefits, while inconsistent with their assumptions, Trade Adjustment Assistance (TAA), which in principle should be the mechanism through which workers suffering from the negative impact of trade would get benefits, showed a negligible increase.

The Birth of the Trump Administration

Furthermore, Autor and others have conducted empirical studies of the effect not only on regional labor markets but also on voting behavior. “A Note on the Effect of Rising Trade Exposure on the 2016 Presidential Election” (*MIT Working Paper*, 2017) by D. H. Autor, D. Dorn, G. H. Hanson and K. Majlesi is one of the newest analyses in this field since the 2016 US presidential election. This study looks at the correlation between the increase in imports from China and the Republican two-party vote share at the county-level in a comparison of the 2000 and 2016 presidential elections using 2SLS. The results imply that accelerating competition from imports from China helped increase the Republican vote. The study also indicates that if the increase in imports from China had been half of what it actually was, the Democratic candidate might have secured the electoral college in Michigan, Wisconsin and Pennsylvania, leading to victory over the Republican candidate.

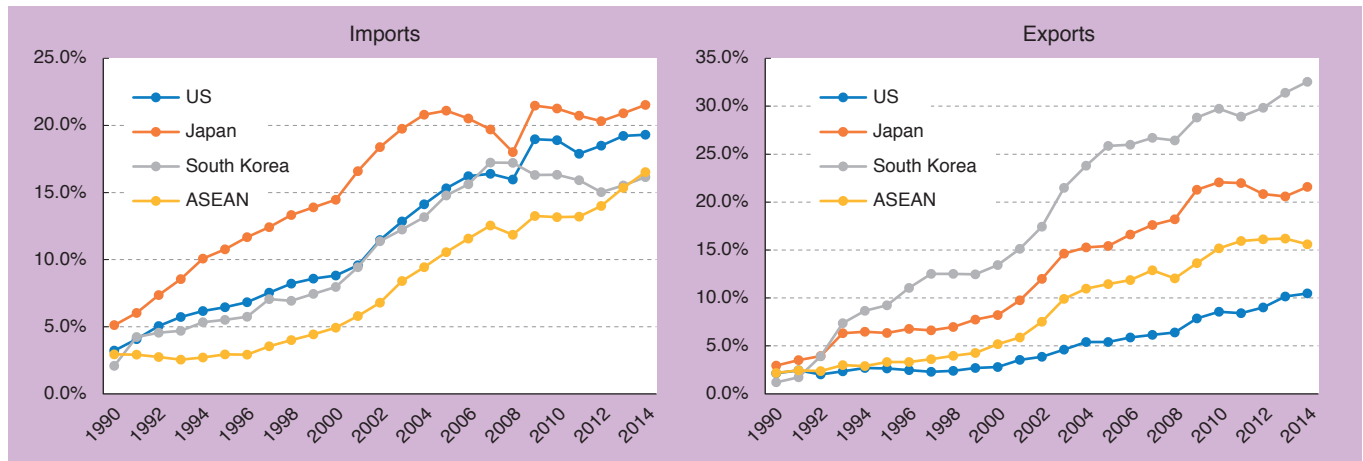
Different Structures of Trade with China Between the US & East Asia

The Case of Japan

There is empirical research that attempts to show whether the

CHART 1

Dependence on trade with China for East Asia & US



Source: RIETI-TID 2014

claims of Autor et al. (2013) apply to Japan as well. In “The Effect of an Increase in Imports from China on Regional Labor Markets in Japan” (*SSRN Working Paper*, No. 2531290, 2016) M. Taniguchi takes Autor et al. (2013) and uses prefecture-level data in Japan from 1995 to 2007 to estimate the effect of imports from China on regional labor markets using 2SLS. As a result, it obtained evidence that regions with greater imports from China tended to have higher growth rates in the manufacturing labor force. Furthermore, the results of the analysis distinguishing between final and intermediate goods imports indicate that much of the positive effect of imports from China on employment depended on the increase in the imports of intermediate goods from China.

The US and East Asia: Degree of Dependence on Trade with China

How does the trade structure with China vary across countries and regions? *Chart 1* separates the percentage of trade with China into that for exports and imports for the US, Japan, South Korea and ASEAN. This tells us that the percentage of trade with China is increasing for all of them. Actually, there is not that much difference in their percentages of imports from China, as the percentage for each fell within the 16-22% range for 2014. In fact, it is actually Japan that has been increasing the percentage of its imports from China significantly since the latter’s accession to the WTO. The increase is slower for the US than for Japan and the percentage is smaller too. South Korea, as we explain later, increased the percentage of its exports to China accompanied by an increase in the percentage of imports from China, making it the most dependent on

trade with China within this group. ASEAN has been increasing the percentage of its imports from China significantly in the 2000s. In other words, the US and East Asia have both been on a similar growth trend as far as imports from China are concerned and are not that different in terms of dependence.

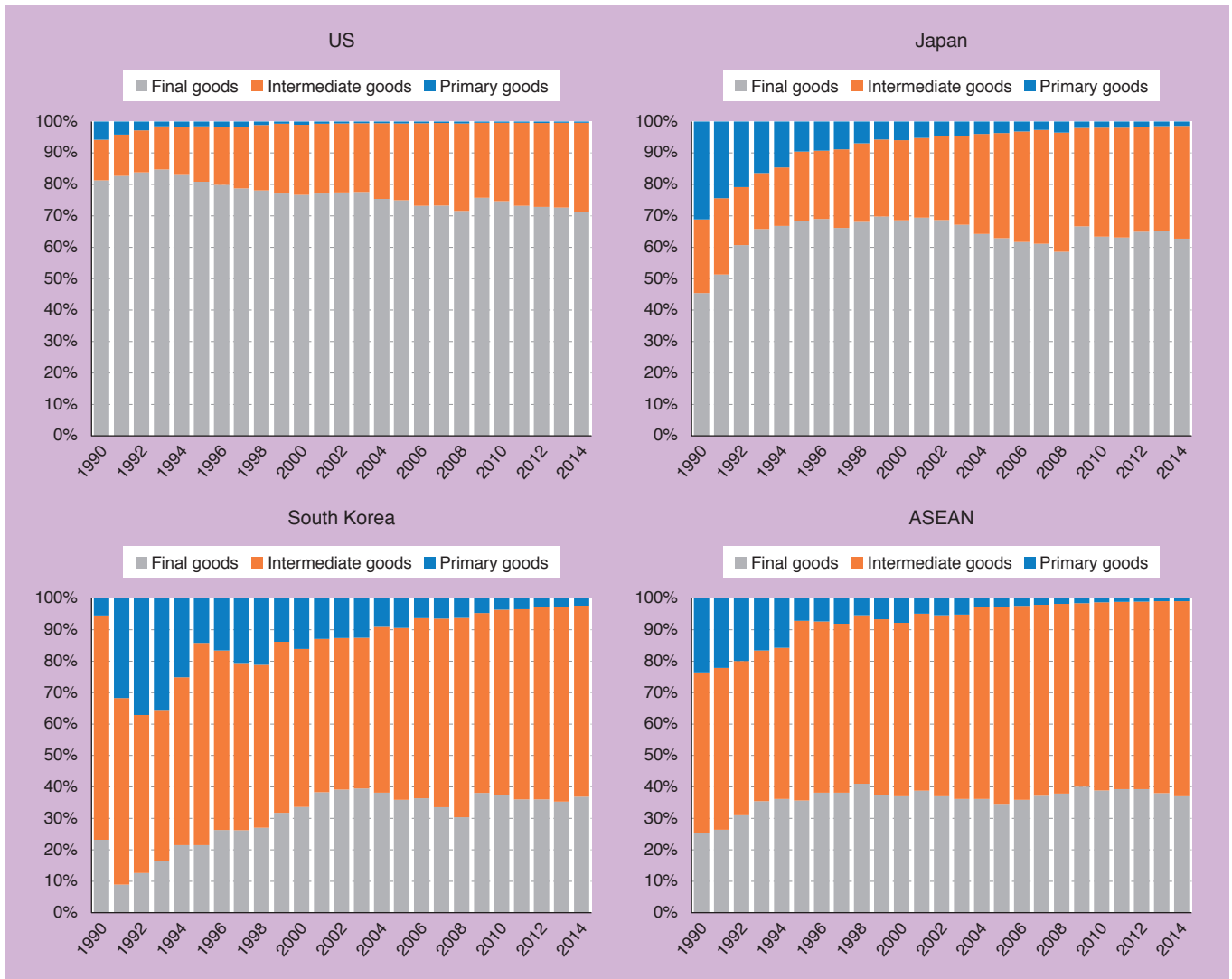
But a focus on exports reveals that the situation is completely different between the US and East Asia. The percentage of exports to China is rising in each country and region, but the increase in percentage points varies significantly. At 1-3% for each country and region in 1990, it rose to 32.6% for South Korea, 21.6% for Japan, 15.6% for ASEAN and 10.5% for the US in 2014, the latest year for which data are available. South Korea stands out in its high dependence on exports to China, followed by Japan. ASEAN has seen a sharp rise since around the turn of the century. On the other hand, the share of exports to China remains low in the US, with merely a 7 percentage point rise. In other words, China’s East Asian neighbors are accepting imports from China while increasing exports there, some larger than imports, but the US has only increased imports from China while it has hardly managed to increase exports to China.

Structure of Imports from China in the US and East Asia

Next, *Chart 2* shows the structure of imports from China by the US, Japan, South Korea and ASEAN from 1990 to 2014. According to the figures, final goods account for approximately 70-80% or more of imports in the US during the entire period. Final goods also account for a high proportion in Japan, but there the percentage of trade in intermediate goods begins rising around 1990 and reaches

CHART 2

Structure of imports from China for US & East Asia by production stage



Source: RIETI-TID 2014

approximately 30% in 2014, higher than that for the US. On the other hand, the percentage of intermediate goods imports is highest for South Korea and ASEAN, accounting for approximately 60% for both. This shows that while the US is slanted towards the import of final goods, the percentage of intermediate goods is higher in Japan, South Korea and ASEAN. As Taniguchi (2016) points out, if there is a positive relationship between the increase of imports of intermediate goods from China and employment, the argument that imports from China led to the growth of employment in Japan becomes

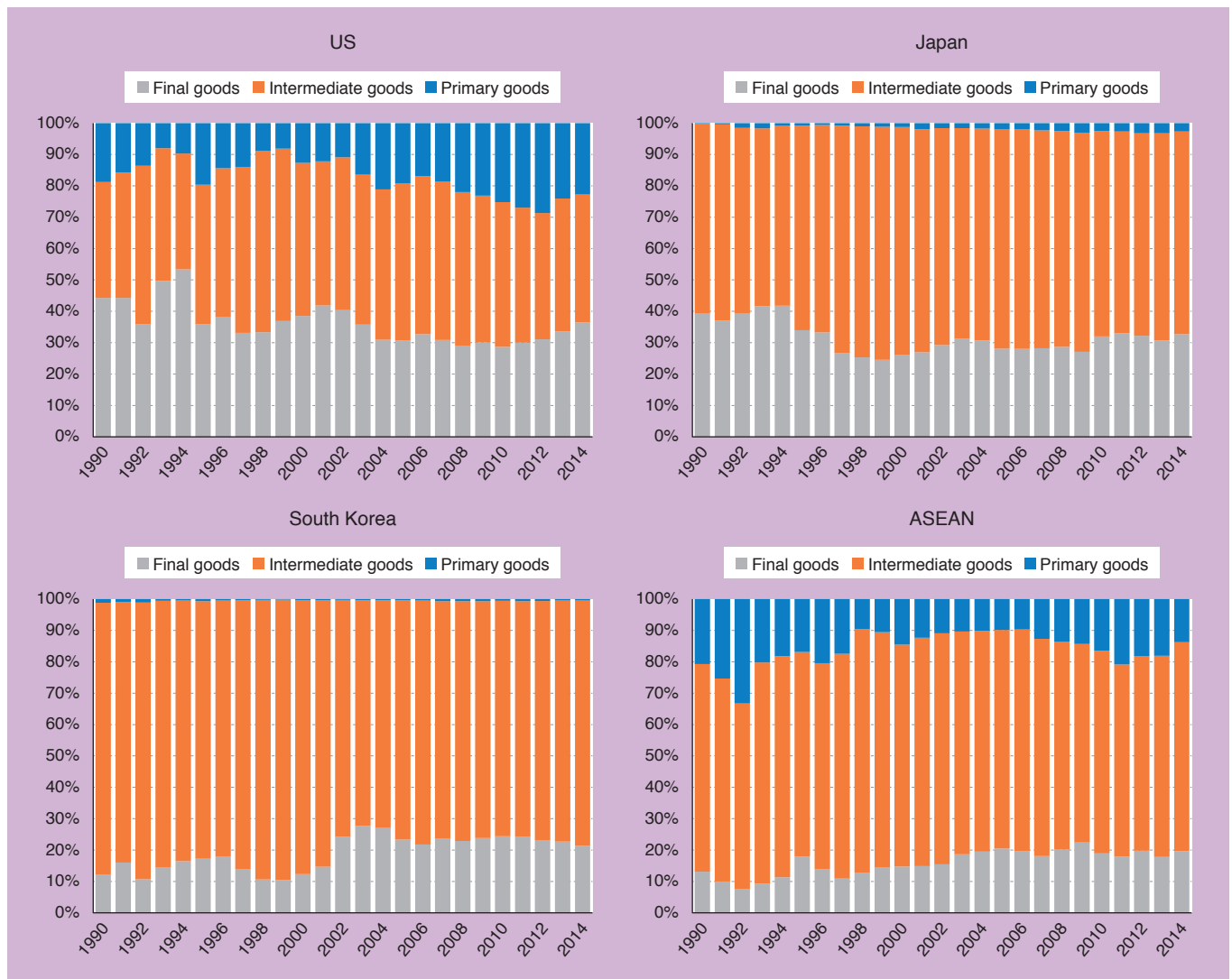
persuasive. However, doubts remain that this can be identified as the key difference in the structure of trade between the two countries, since Japan is similar to the US in that imports of final goods account for the greatest share of imports.

The Structure of Exports to China Between the US and East Asia

How about exports to China? *Chart 3* similarly shows exports to China categorized by stage in the manufacturing chain. What is

CHART 3

Structure of exports to China for US & East Asia by production stage



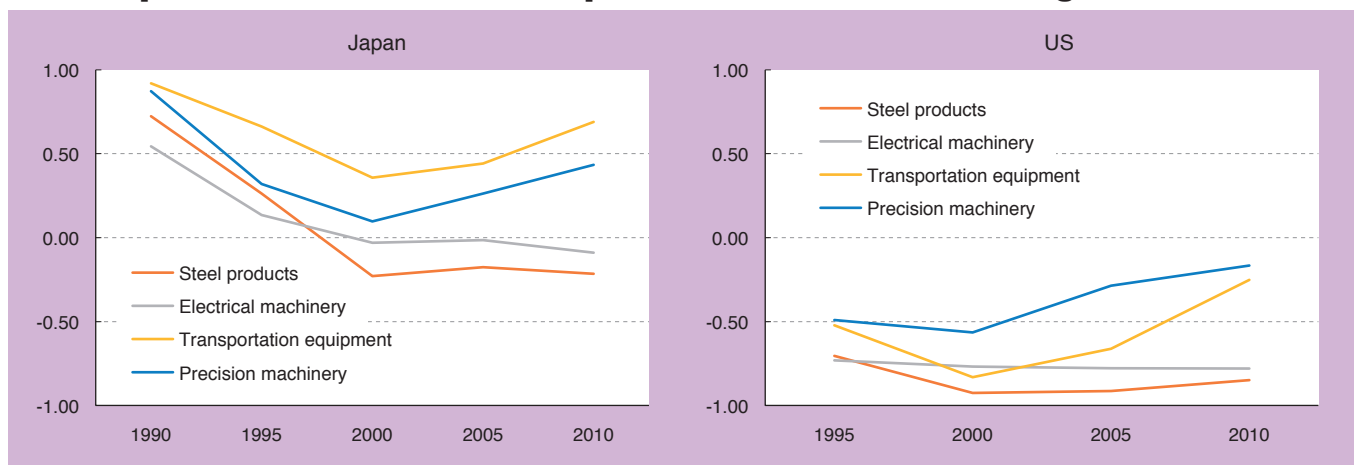
Source RIETI-TID 2014

striking about the case of the US is the fact that the percentage of intermediate goods hardly budged in the 1990s and the 2000s, remaining in the approximately 40-50% range, 40.8% in 2014. By contrast, Japan gradually reduced the percentage of its exports of final goods from the mid-1990s to 2000, with the result that 64.6% of exports were intermediate goods in 2014. In the case of South Korea, approximately 80% to a maximum of 90% of its exports consists of intermediate goods. Intermediate goods account for the largest proportion of exports for ASEAN, at approximately 60-70%.

In other words, the structural difference between the US and East Asia is more evident in exports than imports, and that difference is manifested in the growth in exports and the percentage of intermediate goods in exports. Autor et al. (2013) do not consider the impact of exports since US exports to China are much smaller than US imports from China. Taniguchi (2016) also does not take exports directly into consideration in her analysis since Japanese imports from and exports to China increased on similar trend lines during the period for the data, making it difficult to distinguish

CHART 4

Trade Specialization Index for Japanese & US manufacturing sectors



Note: For industrial classification, the two-digit Harmonized System (HS) Codes shown in parentheses are used: steel products (73), transportation equipment (87), electrical machinery (85) and precision machinery (90).

Source: UN Comtrade

between the effects of the two. However, there is not much difference between the US and Japan as far as the structure of their imports at the different stages of production is concerned. Instead, the growth in exports during the same period and the structure of their exports show significant differences, leading us to suspect that a major cause of the difference between Japan and the US in the impact of trade with China is the difference in the export structure. But that question will be deferred to another occasion, given the limited space available here.

East Asia's Success and US Failure in the Division of Labor with China

The difference between the US and East Asia in the structure of their trade with China reflects the intraregional division of labor in which Japan, South Korea and ASEAN export intermediate goods to China, where they are assembled and/or processed, then re-exported to the US, the EU, Japan, etc. In other words, for East Asia, the rise of China does not pose a threat from a competitor in trade but signifies progress in intraregional trade and investment liberalization, a deepening of the mutually complementary relationship through the expansion of trade in intermediate goods to satisfy Chinese demand, and the enhancement of interdependence.

Chart 4 tracks the Trade Specialization Index (TSI) for the Japanese and US manufacturing sectors from 1990 (1995 for the US manufacturing sector due to data constraints) to 2010. The TSI is derived by dividing net exports (exports minus imports) by gross trade (exports plus imports). Ranging from 1 (exports only) to -1

(imports only), 0 means that exports and imports are perfectly balanced. The closer to 0 the value is, the more that sector is deeper into trade specialization.

The figures show that trade specialization between Japan and China deepened in all sectors between 1990 and 2000. The TSI in 1990 was 0.72 for steel products, 0.92 for transportation equipment, 0.54 for electrical machinery, and 0.87 for precision machinery, meaning that the trade relationship consisted mostly of exports from Japan to China. By 2000, those figures had come closer to 0 for all sectors, at -0.23 for steel products, 0.36 for transportation equipment, -0.03 for electrical machinery, and 0.10 for precision machinery. On the other hand, the US TSI *vis-à-vis* China in 1995 was -0.70 for steel products, -0.52 for transportation equipment, -0.73 for electrical machinery, and -0.49 for precision machinery, and in 2000 -0.93 for steel products, -0.83 for transportation equipment, -0.77 for electrical machinery, and -0.56 for precision machinery. There was no change in the relationship, where the US did most of the importing. In fact, it became even more one-sided for steel products and electrical machinery.

The Side Effects of Protecting Industries

The US claims to be the leader of free trade. However, there have always been exceptions for individual industries. A wide range of protectionist measures have been taken over the years for sugar, textiles, steel, automobiles and so on, such as protection through high tariffs, frequent anti-dumping investigations, Super-301 and other retaliatory measures, setting quantitative targets, and stringent

rules of origin. Typical of all this is the steel industry, which has historically had a major influence on employment in the Rust Belt. It has been the subject of many protectionist measures over decades, such as the import restrictions and local content requirements during the 1980s and activation of safeguard measures in 2002. However, the US steel industry was slow to increase value-added through renewed production capacity and research and development (R&D). The value-added per employee in real terms in the Japanese steel industry has continued to rise since the turn of the century, reaching \$200,000 in 2010, while it remained at approximately \$100,000 for their US counterparts.

In Japan, cheap imports from China did not grow because demand from the construction and shipbuilding industries declined, while domestic production narrowed its focus onto steel plates for autos and other high-value added products, building a division of labor relations with China by exporting high-value added products. By contrast, the US enjoyed strong construction demand aside from a dip during the 2007-2008 financial crisis, and the US auto industry never had to focus on energy conservation and fuel mileage through weight reduction like its Japanese competitors. From this perspective, the US steel industry is paying the high costs of protectionism on trade with China in a sense.

China and ASEAN respectively accounted for 13.9% and 15.4% of the outward foreign direct investment (FDI) stock of Japanese manufacturers as of Dec. 31, 2013; East Asian trade has been supported by intra-firm trade. However, only 5.3% of the outward FDI stock of US manufacturers is in China, raising the possibility that their imports from China were relatively more weighted towards simple third-party sourcing. International comparisons of intra-firm trade are difficult to do because of differences in definition, coverage, industry and product categories and the like. That said, if intra-firm trade is often conducted with differentiation from domestic production in mind, it will be necessary going forward to consider the possibility that differences in the percentage of intra-firm trade have been a determinant of the impact of trade with China on employment and wages.

Further Promotion of Globalism

The Risk for East Asia

In East Asia, where the structure of exports to China is very different from that of the US and the intraregional system of division of labor is actually deepening, the likelihood is small that the region will experience a rise of protectionism of the kind seen in the US. However, several risks can be cited in promoting further trade liberalization.

First is the change in the structure of trade as a result of China's

catching up. If China makes advances in upgrading its industrial structure and makes it possible to supply materials and intermediate goods based on high-level technology superior to those of Japan and South Korea, there is the possibility that its complementary relationship with Japan and South Korea will decline and competition will rise in its stead. Japan and the rest of East Asia must expend their efforts, while always mindful of differentiation with China.

Another point is the lack of a system to even out the effects of labor adjustments under free trade. In the case of Japan, the measures prepared for the TPP negotiations were slanted heavily towards agriculture. But it is necessary to consider a comprehensive system to rescue losers in other industries as well. Moreover, while emerging economies in East Asia are strongly oriented towards growth, they share a common weakness in their redistribution policies and social safety nets. Designing policies to cushion the shock of free trade and systems to compensate the socially disadvantaged will be an important challenge for East Asia.

Conclusion: Where Do We Go from Here?

Globalism has reached an epoch-making political and social crossroads. Most advanced economies are entering the era of a major technological shift with the coming of the Internet of Things and artificial intelligence, among others, that is making significant demands on the labor market, such as higher mobility and elimination of mismatches. However, labor market reform is not that easy, so dissatisfaction regarding employment is more easily directed towards the rest of the world, to imports in existing industries rather than technological innovation at home. This report has demonstrated how East Asia, including Japan, has been able to keep protectionism down because of the success achieved in trade specialization *vis-à-vis* China.

However, given the swift catchup achieved by China, East Asia is no different from the US in that a wide range of reforms such as strengthening R&D and improving locational competitiveness to attract businesses is necessary in order to maintain differentiation. In some ways, East Asia is even more vulnerable to the political temptation to protect vested interests through protectionism. In order to prevent protectionism from rearing its ugly head, it is important to make efforts on labor market reform that spread the benefits of growth from trade liberalization more broadly than now and to further develop the social safety net. **JS**

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