

Interview with Dr. Gary Clyde Hufbauer, Nonresident Senior Fellow at the Peterson Institute for International Economics (PIIE)

# The Future Direction of the Trade War & Role of the WTO

By Japan SPOTLIGHT

We are in the midst of a trade war provoked by US President Donald Trump's tariff policies. What is the outlook for this trade war? Could the WTO stop it? How can we stop a trade war that has been envisaged only in international economics textbooks? Dr. Gary Hufbauer, a distinguished trade policy expert at the Peterson Institute for International Economics (PIIE), responded to our questions in a telephone interview as below.

(Interviewed on July 10, 2018)

## Trump's Provocative Tariffs

**JS:** The recent US tariffs on Chinese goods were closely followed by Chinese retaliatory tariffs. The next step in these tensions between the United States and China may come later this summer. Trump is also considering drafts of executive orders designed to restrict China's access to US technologies that are crucial to military and civilian industries. Is this a correct view of the situation?

**Hufbauer:** Let me add one important qualification. Trump has said that he would wait to see if new legislation passed by Congress would deal with the investment issue, and give him authority to restrict Chinese access to US technology. He made this surprising announcement about 10 days ago and now we are waiting for Congressional legislation. That's a change from the focus on an executive order and instead waiting until legislation is actually enacted.

**JS:** Just to confirm the facts: in August the US is planning the next tranche of tariffs which will amount to around \$16 billion. Is that correct?

**Hufbauer:** Yes, that is correct. That is what Trump is threatening to do, and Trump will go ahead with the additional tariffs. These tariffs are just on Chinese goods. Trump has also asked Commerce Secretary Wilbur Ross to prepare a Section 232 report aimed at putting a 20% or 25% tariff on all auto imports from all countries. Ross has not yet delivered that report, and these are separate from the China tariffs.

**JS:** Thank you for the clarification. Coming back to my first question, this tariff policy is implemented



Dr. Gary Clyde Hufbauer

**based on national security concerns. Would these protectionist measures based on national security be legitimate, based on WTO rules?**

**Hufbauer:** The answer is a little bit complicated. What you said is true of aluminum and steel tariffs and also the threatened auto tariffs. For the China tariffs, Trump has talked about various things, but is using Section 301 of the Trade Act of 1974 to say that China is acting in ways that are "unjustified, unreasonable or discriminatory"

— those are the three words in the legal text and according to Trump, China is doing all these things and therefore he is putting on these tariffs.

Let me talk first about the Section 232 tariffs, which Trump claims are a matter of national security, and venture a guess whether these are legitimate under WTO rules. My answer is a little bit complicated. Firstly, to this date, the WTO has not made an affirmative decision in any national security case. In fact, countries were very disciplined about not using the national security exception until Trump came along. Many WTO members seem to believe that it is up to each member country to define its national security concerns. That's the US government's interpretation of GATT Article 21, which is titled "Security Exception". For almost all other GATT provisions, the WTO dispute settlement body says that it will decide whether the measure was appropriate — whether it be for anti-dumping duties, countervailing duties, tariff changes and so on. But for Article 21, the dispute settlement body has not made any decisions, creating a strong impression that it is up to each country to say what measures are entitled to the security exception. However, if the WTO dispute settlement body now says that it will independently investigate whether the measures are justified under the national security exception, then almost certainly it would determine that these aluminum and steel tariffs were not justified. All sorts of expert

testimony would say that the US has no national security reason for limiting imports of autos or steel or aluminum — certainly not measures that cover all autos, steel and aluminum. If the US had said that it would not import some special type of steel used in missiles, that would be completely different, but the Trump administration said all steel. Likewise for aluminum; I am sure there are special types of aluminum used in military airplanes for example, but Trump said all aluminum. The same goes for autos. So I think that if the WTO actually looked at the substance of US claims, it wouldn't find a national security justification. The big question is whether the WTO dispute settlement body will look at the substance, and that is what we cannot really tell at this stage.

On Section 301, China is challenging the tariffs that were imposed last Friday in the WTO, and no doubt the US will challenge Chinese retaliatory tariffs. Neither set of tariffs is justified; there have been no findings by the WTO that China's actions are discriminating or unjustified or unreasonable. So, until the US actually makes that case in the WTO, there is no basis for it to impose the tariffs. Likewise there is no basis for China to impose its tariffs, but both countries have decided to operate outside the WTO framework for this battle.

**JS: I do not think that any protectionist measures are justified, even against China. However, China is, frankly speaking, practicing some trade or industrial policy measures that are not consistent with international rules. The US could be justified to some extent in forcing China to observe international rules. But the US government is now attempting to enact protectionist measures regarding other allies such as the European Union, Canada and Mexico. I think this would be against the US national interest. Would you concur?**

**Hufbauer:** I agree with you completely, and those countries have retaliated. My colleague Chad P. Bown put a blog on the Institute's website this morning which details the Canadian retaliation and the way the EU retaliated as well on the steel and aluminum tariffs. Mexico either has retaliated or has promised it will retaliate — I don't know whether Mexico has put its tariffs into effect yet, but the EU and Canada have. In terms of national interest, this battle is ridiculous — it is totally against the US national interest to be putting tariffs on imports from military allies, and no previous president would have considered doing this.

## WTO Role in Stopping Trade War

**JS: When and how will the WTO be involved in the consultation process on the dispute settlement mechanism, assuming that the affected parties file a suit against the US policies?**

**Hufbauer:** If a country files a complaint, there is supposed to be consultation. The consultation is supposed to last 60 days, before the

other country requests a panel to be formed. Forming a panel will not be easy because the US will object, or China or the EU will object, to the panelists. So it will be hard to find panelists that the countries agree on, and back and forth consideration of possible names will take a couple of months. Eventually, the director general of the WTO will name the panelists if the countries cannot agree. Then the panelists will commence and hear the pleadings from both sides. That process would last almost a year, taking us up to the middle of 2019 before the panel renders its decision. Then appeals will go to the appellate body, if there are sufficient appellate body members at that time (three is the minimum). There is a good chance there will not be sufficient appellate body members because the US is blocking new appointments, and existing members are coming to the end of their term. If there are not three appellate body members, then the body can't decide a case. That's the rule. So once the body drops down to two members, there is no more appellate body and at that point there is no way a decision can become final without appellate body review. The whole dispute resolution mechanism would have broken down at that point. That is not necessarily what is going to happen, but there is a very good chance that it will. Thus, we may never get a WTO decision on these cases.

**JS: Do you think that any political power could influence such a WTO decision-making process?**

**Hufbauer:** Tetyana Payosova, Jeffrey J. Schott and I recently posted a policy brief on what the WTO could do to satisfy the US objections, some of which are legitimate, to how the appellate body operates. You could look at that policy brief on the PIIE website. It is possible that other WTO members will read our policy brief — it has been up for a month or two — and agree to changes, but I wouldn't say it's probable. If they don't, I don't see how the political system will resolve the situation; instead, you might just see compromise agreements between the US and China and the EU, issue by issue. That is not the WTO, it is bilateral deals, which is how Trump wants to handle trade policy. [Note: subsequent to this interview, the EU issued a paper on the operation of the WTO which picks up some of the proposals in the Payosova, Hufbauer and Schott policy brief.]

**JS: What do you think about the WTO's rule-making function? Is it almost completely dead?**

**Hufbauer:** Almost completely dead. There are some small areas where negotiations are still being carried out, and Alan Wm. Wolff, the American WTO deputy director-general, wrote a nice piece on this. He cited three or four areas where small negotiations are going on, so there are negotiations but not on the big issues. I think there are ongoing discussions on fishery subsidies, for example.

**JS: According to news sources, Trump would like the US to withdraw from the WTO. Do you think this is likely or imminent?**

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**Hufbauer:** Well, he has talked about this. Trump says the WTO is unfair and that the US loses all his cases, and then he says the US is not going to withdraw. If he actually sent notice to other countries that the US is withdrawing from the WTO, that would trigger the six-month withdrawal provision before a country can leave. However, giving the notice is not the same as actually withdrawing. If Trump issues a notice, nothing will take effect until 2019, but meanwhile Congress will be very, very upset because Congress regards trade as its area under the constitution. Article 1, Section 8 assigns the power over foreign commerce to Congress, not to the president. Congress will certainly be agitated if the president issues a withdrawal letter, and it is unlikely that Congress will allow the president to take the second step of actual withdrawal six months later. Actual withdrawal would mean that promises that other countries have made about maximum tariffs on US exports would no longer have any value. Other countries could legally put a 20% tariff on US exports of turbines or soybeans or anything else. Congressmen representing exporters would be violently opposed to this possibility. Trump has been briefed about these consequences and so I don't think that he will withdraw from the WTO.

### Economic & Political Consequences of Trade War

**JS: Let's talk about automobiles. Japanese auto-business people are pretty worried about the possible outcome of tariffs on automobiles; a 20% or 25% tariff would have significant impact on global trade and the economy. How do you estimate the impact?**

**Hufbauer:** My colleagues Sherman Robinson and Mary Lovely have posted quantitative estimates. A 25% tariff would be enormous, and would hit Europe, Canada, Mexico, Japan and South Korea. I am very skeptical that Trump will do it, but if he does put a 25% tariff on autos, that would trigger a big trade war. My colleagues argue that this would disrupt supply chains in the industry, and in the course of retaliation, some 200,000 employees in the US would lose their jobs. Autos sold in the US would be \$2,000 to \$7,000 more expensive. For these reasons, I don't think Trump is going to impose tariffs on all US auto imports, but a 20% tariff on luxury autos from Europe is more likely. Trump doesn't like Europe, so he could put a 20% tariff on Mercedes, BMW, Porsche autos. He would then say to working-class American people that the rich people could afford to pay a tariff on these autos. [Note: after this interview, Trump agreed on a tariff truce with the EU.]

**JS: Including other protectionist measures to be taken by the Trump administration that could cause retaliation by China, these trade wars stand to have a serious impact on the global economy. The global economy is in relatively good shape, and so in the short term the negative impacts of a trade war could be limited but more significant in the longer term.**

**Hufbauer:** If everything that Trump has threatened actually happens — and of course other countries will retaliate — I think we will face a global recession. There would be so much dislocation in the global economy. The reason you get a recession is not only because trade is dislocated, but multinational business firms will wonder what the world is coming to, with the major powers fighting a tariff war with each other. What is the business motivation to make new investments with a tariff war going on? So I think that big companies will cut back on their investment plans, which would cause a recession. It doesn't matter as much what US consumers do, as they basically spend most of their income anyway, but if investment goes down, that affects the entire economy and will lead to a recession. Unemployment will rise and of course stock markets around the world would take a sharp hit. That would be the outcome of the action that Trump has threatened.

**JS: Regarding the political perspective in the short term, perhaps the US economy's favorable condition could conceal the negative impact of these protectionist measures?**

**Hufbauer:** In the short run, I agree. The US has a strong economy and can take this kind of blow better than other countries can. But I think the short run is a year at most. I think weakness abroad will come back and hit the US. The investment uncertainty that I emphasized — US firms wouldn't really know what to invest in. If Apple invests in more iPhones, who is going to buy them? Is China or India going to buy them? We have had a period of 70 years where the rules of trade have been respected by the major countries, but now you would have a situation where major countries would not be respecting the rules, and companies would have to think about who is going to buy the things they produce, and doubts about investment will come back to hit the US.

**JS: Do you think that concerns about protectionism would have an impact upon the mid-term elections?**

**Hufbauer:** It's having an impact in the farm states because farmers realize that their prices are lower because of what has already happened. Affected farmers are concentrated in the so-called "red states", the Republican states. I don't know whether Trump will lose many red states in the election, but he might lose some Congressmen because farmers are unhappy. Plenty of other firms besides farming are hurt, but I think that for them the hurt is not concentrated enough to swing the politics. What Trump is saying is that Americans must stand up to China — otherwise China will dominate us and take over our industries. So if you are a patriotic American you must support his policies. Many farmers are very skeptical and don't believe that line, but maybe people in industrial cities accept Trump's argument. That is what the election will be about. If we get more pain, and more retaliation, then more people will switch to opposing Trump, but at the moment we are at the initial stages of a big national debate.

**JS: Thinking about the sources of this trade war, the**

**global imbalance seems to be the main issue. This is presumably more to do with macro policy as opposed to trade policy?**

**Hufbauer:** Yes, the big issue is the US-global imbalance. Trump talks about bilateral imbalances but a country will have bilateral imbalances, even if it has a global balance. Trump is concerned about both bilateral deficits and the US global deficit — the latter as you mention is a macro issue. I don't think it's a problem, but Trump thinks it's a big problem. There are three ways to cure a global trade deficit, all of which are much less pleasant than the problem itself. The first way is to devalue the dollar, to ask the Federal Reserve to devalue the dollar 25% on a trade-weighted basis. It is not at all clear that the president can tell the Federal Reserve to do that, however. Such a move would cause a lot of distress in the global economy as well as the US economy — inflation and a falling stock market. The second way would be to get rid of the US fiscal deficit by raising taxes. But Trump doesn't want to raise taxes, that is the opposite of what he wants. If you raise taxes by a trillion and a half dollars a year, you will get rid of the fiscal deficit and the trade deficit. But you will have a recession as well. The third way — and these are all overlapping — is you can trigger a recession by destroying business confidence, for example by a global trade war. When the US has a recession, the trade deficit goes down. Of course, that will mean Trump is out of office in 2020. All of these macroeconomic approaches create problems bigger than the trade deficit; that is the reality even if Trump does not accept it. He thinks that by going after individual countries he can reduce the global trade deficit — this is what he tells the American people.

**JS: Looking at the Chinese economy, I am sure that it will suffer from this trade war. Do you think it could withstand such a trade war?**

**Hufbauer:** The difference between China and the US is that China is an authoritarian country. The Communist Party controls the press, the people, business firms, the provincial governments and everything else. The Chinese government is telling the population that it is their patriotic duty to stand up to America; in the past, China has endured much more painful measures than what we are talking about here. Mao's great revolution was a disaster — millions of Chinese died, and everybody was impoverished. In economic terms, China will suffer a lot but political control is strong enough that the suffering will be accepted. In the US, conversely, the economic suffering will be much less, but the political acceptance of suffering is very much lower than in China. Trump supporters may accept economic distress in the short run, but they will fall away as the suffering gets more severe.

**JS: In thinking about the outlook for a trade war between the US and China, do you think China would make any concessions in light of the potential negative outcomes for its economy?**

**Hufbauer:** Yes, they did offer at one point to buy \$70 billion more of

US goods but that was a concession which Trump did not accept. China has already cut the tariffs on autos from 25% to 15% and they could cut other tariffs too. But Trump and his team have to be willing to accept modest concessions; they can't expect China to do everything that they want. Some people on the Trump team see China as the big adversary and they are not willing to accept modest concessions; they want the China that existed in 1980, not the China that exists in 2018. I am talking about hawks like Director of Trade and Industrial Policy Peter Navarro and National Security Adviser John Bolton. Everything depends on whether Trump listens to them.

**JS: Do you think there is likely to be a Chinese policy for strengthening regulations to protect international property rights?**

**Hufbauer:** That would be in China's own interest, because what they have been doing is sufficiently aggressive and unpopular that multinational companies are very skeptical about bringing their new technologies to China. China is hurting itself by espionage and forced technology transfer. At some point China will recognize this and will change its policies. Look at the example of Japan — it has a whole range of first-class technologies, autos, medicine, world-beating machinery, but Japan respects intellectual property so companies worldwide are willing to partner with Japanese companies. It is clear what China could achieve were it to adopt a different attitude.

**JS: On the US side, would there perhaps be room for compromise in thinking about national security issues because China is a very important country regarding security issues in Asia, particularly with relation to North Korea?**

**Hufbauer:** Absolutely. The Trump administration can easily modify its elastic views on national security. At the beginning of our conversation we talked about the executive order. They didn't issue this executive order for two reasons: one, Congress is making progress on new legislation and two, Secretary of State Mike Pompeo told Trump that if he issued the planned executive order, China might not cooperate so much on the North Korea file. So that was why Trump reversed course on this executive order; the China angle was very important. I do think that Trump could greatly modify his national security statements and he would not lose any votes in the US; he would actually make himself more popular with Congress where many members object to his national security tariffs. This is an area where Trump could compromise.

**New Global Governance Scheme****JS: Let's look at global governance. China recently strongly advocated for free trade and the role of the WTO. Do you think China could potentially be a new leader of the WTO?**

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**Hufbauer:** Yes, it could. It is very plausible. It really depends on whether President Xi Jinping is willing to make concessions, to reduce Chinese tariffs, respect intellectual property and not give large subsidies to state-owned enterprises. If he is willing to do such things, China could easily take over leadership of the WTO. It is amazing that the US is implicitly offering to let China to take over the leadership, albeit unintentionally. More likely is some kind of coalition between the EU and China, as equal partners, with the US out of the picture. If the WTO survives, that is how it will survive.

### JS: Why do you think that a China-EU alliance would be possible?

**Hufbauer:** Well, both because the US has been so disrespectful of its European allies, and because the grievances between the EU and China are not as big as those between China and the US. The EU doesn't have such a big trade deficit with China, and the EU is more willing to take an approach of negotiation rather than confrontation on intellectual property issues. Both the EU and China see the US as going on a very odd course of isolation and protectionism, and both of them understand and appreciate the value of the open world trading system. So there is a coincidence of interest. Those are the reasons why it could happen.

### JS: How do you see the role of the TPP/RCEP or other regional economic integration bodies in preventing trade wars?

**Hufbauer:** The TPP depends entirely on Japanese leadership at this point, and I guess it will be ratified by the requisite number of countries in January 2019. And if Japan takes the view that it will be good to enlarge the TPP to add other countries that want to come in like Colombia, Thailand and South Korea, then the TPP could become a real force. The TPP, actually the CPTPP now, is a very positive force in the international economy at the moment. It is possible that a future president post-Trump will see the error of US withdrawal from the TPP and will want to join. I am more skeptical about the RCEP, which has the big problem that it encompasses both China and India. India is so far from being an open market economy, and is quite afraid of China, so there is a lot of internal tension within RCEP. And the agreement is not strong on trade and investment rules. So I think its formation will be slow and it will not have nearly the same strength as the CPTPP.

### JS: What do you think about the role of APEC?

**Hufbauer:** APEC has become a bit like the G7 (which the US walked out of and thus devalued). The best thing APEC does is that the leaders meet and actually talk to one another and that reduces tension. But it will never be a rule-making body or an organization giving much guidance. It is kind of an umbrella organization that publishes useful things, a little like the OECD but not as strong. But it won't be a meaningful trade or investment rule-making body. It tried that in the beginning, but that hasn't transpired.

**JS: In global governance, my observation is that many issues are intertwined today, including national security and economic interests, and also structural reform and trade liberalization are also closely intermeshed. That means that WTO-type international organizations may not necessarily be powerful in solving global economic issues.**

**Hufbauer:** You may be right. Organizations like APEC or the WTO can usually point out examples where country policies have succeeded and where they have failed. That they can do. But we may be at a period in time where the major powers don't want more rules from multilateral organizations. The US certainly won't accept more rules and so why should other major powers? I agree with what you just said.

## Restoration of WTO

### JS: How do you think we can restore the WTO as a rule-making body in the future?

**Hufbauer:** I think there are a few things that need to be done. First of all, we need a combination of Japanese-Chinese and EU leadership. We used to have Japan-Canada-US-Europe, but the US is out of the picture now. So it is down to Japan, China and Europe to get together and make serious efforts to restore the WTO. Secondly, the WTO must agree that the way forward with regard to making rules is by plurilateral agreements covering a subset of WTO members. We are never going to get 164 countries agreeing to multilateral rules on important subjects. There will always be one country, like India, that disagrees. But there are plenty of areas where we could have plurilateral agreements where the three powers that I mentioned could work constructively and other countries could join or not as they wish. The first one might be the Trade in Services Agreement (TISA) which got a fair distance on a plurilateral basis before Trump came to office; that was the end of it as far as the US is concerned, but other countries should take it up because TISA could have an enormous positive impact on globalization going forward. Digital trade is another area, state-owned enterprises another. There are many areas where there could be meaningful trilateral agreements but it really depends on China, Japan and the EU seeing that as worthwhile to build up the WTO.

### JS: How about sectoral agreements?

**Hufbauer:** That is what I mean by plurilateral agreements that don't involve all the members to deal with a specific issue. You might have 30 members, you might have 50; that is the way forward. **JS**

Written with the cooperation of Joel Challender, who is a translator, interpreter, researcher and writer specializing in Japanese disaster preparedness.