

Interview with Christina L. Davis, Professor of Government, Harvard University

Outlook for Trade Wars & Global Governance

By Japan SPOTLIGHT

Trade wars are the biggest concern today for the global economy. We had an opportunity to interview another distinguished expert on international trade and political economy, Prof. Christina L. Davis of Harvard University.

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Trump Administration's Trade Policy

JS: Firstly, you discuss in your *Financial Times* article a few weeks ago the claim by US President Donald Trump that his trade policy is based on national security. You suggest that this is a somewhat abusive use of the concept of national security. Could you elaborate on this?

Davis: Yes indeed. It really is a challenge to rules for predictable and fair trade when countries — on an arbitrary basis — define national security broadly. The GATT first and then the WTO have recognized that there may be circumstances where countries need to use economic policy in times of national crisis related to war and conflict and economic sanctions etc., and that is why there are special provisions that allow for trade restrictions for national security. But the norm has always been to avoid using those, and it's very worrisome now to see the United States invoking with Section 232 a national security basis for tariffs on steel and aluminum and now considering automobiles. That's very different from the idea of trade sanctions in times of war, or of course those that accompany enforcement of a UN Resolution for security actions. So the US measure is quite unusual — in US policy this rule has been on the books but not used; in the WTO, Article 21 on national security exceptions has been in the rules but rarely invoked. So both within the national context and the multilateral trade system, this is an extreme step.

JS: Meanwhile, this national security concept seems to have been used for foreign direct investment (FDI) restrictions, and today I suppose that the conflicts between China and the US do seem to be somewhat concentrated on high-tech competition. FDI restrictions based upon national security seem to be closely related to this high technology competition. How do you view this phenomenon?



Dr. Christina L. Davis

Davis: It's difficult. They are trying to back out of a globally integrated trading system and you can't really take it apart now. The idea that you can selectively target Chinese smartphones and semiconductors as a way to stop them having access to high technology is simplistic and will lead us in the wrong direction because China is quickly developing its own domestic capacity for high technology. I know from both Princeton and Harvard that there are leading scientists there and incredibly smart students, and I am sure within the Chinese universities there is also an abundance of talent, and so we are not going to be able to stop China from

developing the next step of industrial capacity, and high technology is clearly a priority. For the US to try and enforce intellectual property rules that are commonly agreed on — yes. To try and move forward those rules — yes. But stopping trade and investment deals out of concern for security threats is more difficult. There are some American companies producing technology that could be used by another country for cyber warfare or other military applications; so there are some technologies for which you do need a review process. But again, that is where the Trump administration has taken a reasonable principle and gone too far. There are few industries where one might say that they are so close to direct defense applications that a restriction could be justified.

JS: Apparently, there seems to be no clear international rule concerning FDI.

Davis: Think about the OECD effort to have a multilateral investment agreement in the 1990s — and of course because they couldn't reach a multilateral agreement governments have continued to rely on bilateral investment treaties that are largely about protecting a firm from expropriation. Most of these bilateral agreements don't even consider a lot of these issues about the conditions for when is investment allowed, what are the review principles, and so on.

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JS: Under these circumstances, don't we need some rules on FDI?

Davis: I do agree that there is a real gap in global governance on foreign investment and it would be in the interests of most countries to negotiate a multilateral framework. And I think maybe multinational firms might now see it as being in their interest too to come to an agreement. The US has long had this process to review FDI implications for its national security. The policy hadn't been used as much and so wasn't a major public issue, and now of course because they are using it more often against Chinese firms it has become controversial. But at the same time, other countries are imitating this type of policy — Europe is developing its own FDI national security review process and so is China, so we will begin to see more politicization of foreign investment.

JS: I suppose there should be a balance between national security and national efficiency in this domain.

Davis: Another interesting aspect when thinking about the investment-trade link is that these multinational firms are getting caught in both sides of the trade war; they make an investment in the US to build a factory that will export some cars to the US and some cars to China and Europe — and now they are getting hit with tariffs as retaliation. There are articles about how German car companies or Nissan are going to have their American factories suffer because of the European and Chinese retaliation against automobiles. A lot of these companies built in the US hoping to both sell to the US and export from the US and then they get caught in the trade wars. I can see multilateral investments facing higher risk premiums because of this type of uncertainty now. It's not as easy to hop trade barriers when you are not sure which side is going to be retaliating, and it's expensive to build these factories and then have them not reach the intended market.

Could the WTO Work to Prevent Trade War?

JS: There are lots of expectations about the WTO, but it doesn't seem to be functioning that well. How do you think the WTO could work to prevent trade wars?

Davis: One hopes this system can be used to enforce rules, and the administrations of both former President Barack Obama and Trump have filed complaints at the WTO to try and resolve some of the concerns that the US has with China, and Japan and Europe have joined in with complaints against China, so the dispute system is one path to work out these issues. Negotiations need to go forward as a second path, and that has been where the WTO really hit a roadblock with the Doha Round failing to bring a result. If we think about why China can still have reasonably high tariffs, it's because after joining in 2001 they haven't had a new multilateral trade round that through reciprocity forced them to lower tariffs. Under the new concerns about state-owned enterprises or the desire to strengthen investment

rules, all of those should have been negotiated in a *quid pro quo* trade round, but nothing came of it and so now we are left with a trade war outside of the multilateral rules.

JS: Do you think the WTO dispute settlement mechanism would work well in the current circumstances?

Davis: It hasn't worked completely. The Trump administration complains that the system is unfair if the US loses. The US frustration is just because the US loses on anti-dumping, and he doesn't notice that if they tallied all of the cases the US does win the majority of the complaints that it has brought to the WTO. There is a sense in this administration that the dispute settlement process is not enough, and so that is one reason why they have tried to enforce US trade interests through means outside of the WTO, and that is part of the dissatisfaction with dispute settlement, and it reflects a sense that the rules themselves don't cover the issues that are important. For example, expropriating technology from foreign firms is just not in the rules and would be difficult to bring as a case to the dispute system.

Regarding the WTO preventing trade wars, I wish that Europe and Mexico and Canada had focused on their WTO dispute challenging the US policy and not undertaken retaliation. That has been the policy of Japan and Russia and India. Russia and India do not do retaliation because their markets are not big enough and it would not hurt the US — but they were able to use the WTO dispute to at least show that they were responding to Trump's tariffs. So for those countries, dispute settlement gave them something they could do when the US was hurting their interests, and for Europe they should first file a complaint, and then they have had their retaliation later based on a ruling of the WTO against the US policy. But because they retaliated first, their policies would likely suffer as a violation of the rules when challenged by the US.

JS: As you mentioned, the WTO has the role of rule-maker, besides its dispute-settling mechanism. Almost everybody is saying now that this rule-making function is already dead, after the collapse of the Doha Round. How do you see the role of the WTO as a rule-maker?

Davis: I think that is a critical weakness, and we need to think about the ability of countries to negotiate new rules. The one silver lining from the current trade conflict is that it could motivate countries like China and India to engage with the WTO more seriously. If we were to consider why the Doha Round failed, I think that too many countries thought that the status quo was just fine and would continue; so they didn't want to make tough concessions for new rules. But the US is saying that the status quo is not acceptable and through this trade war is raising the costs for other countries. So to try and get back to its rule-making function, the WTO needs a trade round that would rethink the rules, and as I wrote for my *Financial Times* article, I think that China should take the lead. By this I do not mean that China should write all the rules in their own favor, but

rather that China needs to take the lead by making hard concessions, opening their markets and surprising countries with an agreement to provide more transparency on state subsidies. I don't know if that will happen, but such proposals would be the kind of action that is needed to strengthen the multilateral trade system.

Future of Global Governance

JS: Regarding other global governance schemes such as the G7 or G20, to my knowledge the G7 summit did not go well last time. In your assessment, has the G20 been working well?

Davis: Well, the G20 was useful during the financial crisis of 2007-2008 as a mechanism to bring everyone together and see that tit-for-tat retaliation and raising trade barriers would be dangerous. I think that the high point for the G20 was that it provided a meeting point during that crisis; I don't see it rising to the occasion now, but one could hope that the 20 leading countries could get together to reach an informal agreement to restrain the use of national security for restricting trade and investment. Maybe this will occur in a future meeting, but the G20 hasn't played that role yet.

JS: How do you think we can restore global governance today? Maybe the G20 does not necessarily constitute the only mechanism with global governance functions.

Davis: I think that strengthening the WTO is important, and trying to get a trade round to work through these difficult disputes. It is one of the most important institutions for global governance and is facing challenges both on the enforcement and the rule-making side and so this should be the first priority. If the G20 can support that effort, it would be a useful contribution. I also see the OECD having a role and this is where global governance is not just the elites meeting and coming up with rules, because the crisis we face right now is a populist backlash against elites, and so we need to think creatively about how can we come up with better ways to design trade adjustment programs so that the small sectors that lose from trade are given the right time for transition and training programs. Are there ways we can learn from other countries or think of new models and share those so that we can prevent the kind of anger that is popping up in the US and other countries? That is where the OECD can function as a think tank in coming up with new ideas. At the same time, the OECD has been working with the WTO on measuring value-added trade. One of the challenges right now is that the Trump administration portrays trade as win-loss in terms of your trade balance — if you have a surplus or a deficit. We need to spread a better understanding of a global market and global production; it's really nonsensical to think about trade in terms of national trade balances.

JS: So you see the OECD as a good venue for such education?

Davis: As an educator I have my own role teaching students and researching policy, but think tanks also need to consider how they can — at the elite level — come up with policy plans and consider ways to improve education and understanding among the public: the OECD has expanded the scope of its activities from governance of business practices to include standards of education. Could they ever bring that together and help countries? How do you educate your population about the winners and losers from trade?

JS: The OECD once published a kind of report on the cost and benefits of free trade, and I think it was well received, particularly by the American delegation. Would you agree that such efforts to clearly elucidate the merits of free trade are important?

Davis: I remember reading extensively the OECD reports on the cost of agricultural protection, and by giving clear numbers about how much money is being spent on agricultural protection it really contributed to the public awareness but also the ability for governments to negotiate. Simply putting a clear metric for measuring agricultural protection served one role in providing education on the costs and benefits, and a second role in giving a metric to negotiate agricultural agreements that are now part of the WTO. So there might be new ways where the OECD could educate about value-chains of trade and facilitate more effective negotiations in a global economy.

JS: Also, structural reforms including domestic policies would be very important to maximize the benefits of free trade. Is that correct?

Davis: Indeed. How do we encourage structural reform in a way that supports the livelihoods of people in communities? Thinking about the timing of these reforms is important, and Japan has taken the slow path to structural reform in the agricultural sector which has been expensive for the national budget, but on the other hand has perhaps helped to avoid a rural backlash against globalization because the young people have been able to get jobs by moving to cities while older people remaining in the countryside are given a higher income through extensive government support. So I think that structural reform is necessary but doesn't always have to be rapid, and shock therapy is maybe economically efficient but politically dangerous.

JS: Perhaps we can create a sort of peer-review pressure by discussing trade liberalization and structural reform simultaneously. I believe the OECD is a good venue for such international discussion.

Davis: Yes, as a comprehensive organization it is the right place to think about both domestic economic policies relating to everything from pensions to corporate governance, and to external policies of trade liberalization and financial liberalization. So I think the OECD is one of the few organizations that has the breadth to fully address structural reform and liberalization as a joint process. One of the

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problems of the WTO is that it just deals with trade liberalization and has assumed domestic governance will undertake structural reform and do trade adjustment assistance for declining sectors.

JS: For security issues and geopolitical risks, these should be discussed together with trade and structural reform as we live in a complex, intertwined world where everything is closely related. In that sense, the OECD may not be the venue for discussing security, and perhaps we need other venues like APEC.

Davis: APEC or the G20 are the two global governance institutions that both talk about some security issues as well as economic issues. APEC is an interesting group in that it has such a broad membership, but it has not to date been proposing creative solutions to economic problems, and so it seems less likely to me that it would come up with a solution. Maybe if Japan and China were to take the initiative together there would be a possibility. The fact that APEC does not include Europe is difficult because it really means Japan and China must jointly push forward an agenda. The US right now is quite passive if not hostile to such efforts. It would be great if Japan and China could see a mutual interest and join hands on a proposal on how to resolve national security linkages and economic governance.

JS: In your *Financial Times* article you seem to regard China as playing an important role in trade liberalization from now on. Could it be a leader of the WTO?

Davis: I think they should and it would be in their interest to do so, but in terms of whether they will, I am not confident. The leadership of China right now appears more focused on internal control and has not been putting forward ambitious liberalization proposals. They have endorsed liberal rules at Davos, and more recently have chastised Trump's policies as being the wrong way to go and said that we should support multilateral trade rules. In this sense, the rhetoric of China has indeed been very supportive of the WTO. But we haven't seen them come forward — either unilaterally or at a WTO ministerial or APEC ministerial — with a proposal that would show a willingness for China to take a reform itself, whether it's market opening with lowering tariffs or rules strengthening on transparency of trade or new policies on competition and digital trade. Nothing like that has been forthcoming, and while I do think that China should become a leader and I hope it will, I have not seen evidence to date.

JS: To my knowledge, China is very much interested in a domestic policy agenda as it has a problem in its structural economic reforms. In this context it might be better to discuss trade and domestic policy issues simultaneously, outside of the WTO.

Davis: I don't think that China wants to discuss its domestic problems internationally. I agree with the need to consider structural adjustment jointly with liberalization but structural adjustment is very much touching on sovereignty, and so countries like China that are especially sensitive about control over domestic policies are less likely to want to have those issues discussed at a multilateral venue.

JS: Coming back to the OECD and APEC, these are informal venues and not for negotiations. At this moment, perhaps it would be better for us to have good discussions in such informal venues rather than negotiation venues.

Davis: Informal venues can be useful for building confidence and trust, and certainly we have seen a breakdown in both of these, so I think there is a role for summits to try and improve relations, and you can't go forward and make new formal rules when you don't trust the other side and think they will cheat. I think this is a good time to move forward if possible with building confidence and showing some mutual interest in reaching an agreement through talking at an informal level; if we can get past the name-calling and insults from the last informal meeting at the G7, then perhaps we can build better relations among leaders and confidence and this would lead them back to a formal setting. Informal meetings are never going to be enough because there is always this tendency to have a vague declaration of agreement on peace and prosperity, and this doesn't do anything when it comes down to protecting a specific industry. What is allowed and what isn't allowed requires a more specific rule and it requires someone to interpret that rule when it is applied in a specific case.

JS: Do you think such informal meetings could create peer pressure?

Davis: For normal times, yes. I am a little worried, however, whether peer pressure will be effective now that populism is the political tide. Trump and other leaders actually gain popularity with their constituency by causing a fight at a multilateral venue. So far from there being peer pressure, it may be that getting into a fight at some public forum is helping their domestic stance of fighting for the national cause. Thus, peer pressure has to be done very carefully to avoid a backlash.

JS: Apart from the OECD or APEC, there seem to be lots of proposals concerning possible restoration of global governance, and one of them seems to be the role of middle powers such as Japan, Canada and the EU. Can they join forces in order to restore free trade?

Davis: Yes, we certainly saw this with the TPP where Japan stepped up when the US withdrew, and Japanese diplomats worked very hard to keep the agreement going forward. It wasn't easy to persuade Vietnam and other countries that wanted access to US markets that there still was something to gain from an agreement without the US.

This was a big step. The idea that put a waiver on the intellectual property rights claims that only the US had wanted was quite useful because it puts pressure on the US to eventually join if it wants to achieve those. So I think that Japan's role in the TPP was quite good. It went forward with liberalization in a way that could apply pressure on the US while still saying that they wanted the US to join, and I hope that we'll see this with other countries in future. The EU-Japan agreement is similar where they have gone forward with their liberalization showing that they can reach good agreements that have a lot of the policies that the US would probably want. Now US exports will face pressure from that because they are at a disadvantage.

Long-Term Impact of Trade Wars & Future Prospects

JS: Presumably, in the long term the global economy is going to significantly suffer from these trade wars. In the short term it may not be so serious. How do you see the impact of trade wars on the global economy?

Davis: The actual amount of trade restricted is still small enough that we are probably not seeing a major negative impact. At this point, even the US stock market is holding up OK, although China is suffering a little from stock market decline and its currency losing value. I think we are still at an early stage and if this expands further it would include more trade, which would certainly harm economic welfare. More serious damage could arise if the trade conflict continues further because there will be such a loss of confidence that businesses would stop investing, and then the harm would not just be the tariff barriers but rather all of these foreign firms that might have otherwise invested in a new plant but now don't know if they should because there might be new trade barriers. It could easily make a lot of investors more cautious about expanding production, and of course this is what lays the basis for economic decline because everyone becomes nervous about investing. I think there is a direct effect from trade barriers hurting specific jobs such as farmers or some industries abroad such as steel. I think that if this continues we will lose business confidence and this could trigger major economic consequences.

JS: How about the outlook for this US-China trade war? I think the Chinese economy may not withstand the pressure very well and may have to make concessions eventually. The US might have an interest in national security concerns in Asia including the Korean Peninsula, which might lead to its making concessions.

Davis: The Chinese government may make concessions to forestall any further harm to their economy. The US — especially if the Trump administration enjoys a victory in the November election — will be in a good position to accept some concessions to stop the tariffs. The Republican Party has long supported free trade, and the business

interests and the farm interests that have traditionally supported the Republican Party are all in favor of free trade, and so there is a scenario where the Trump administration's position will continue but retrench when there are signs of concessions from China after the election. So this may prove to be a short period of tensions. The negative view is that China also faces domestic political pressure and does not want to make a concession. The Trump administration has already shown that it does not answer to the Chamber of Commerce or traditional Republican ideology. So, I would put it 50-50 as to the possibility of the short trade war being over by December, or if we are actually going to see this continue, because the current trend in the US is towards a dramatic challenge of the trade system. China has yet to learn how to navigate this trade conflict and they might make mistakes. That is how wars happen, if both sides think they can win; but in reality they can't, you can get into a long war that nobody wants.

JS: Japan is concerned that further possible tariffs on autos could break global supply chains and the fallout could be enormous. Do you think that tariffs on auto imports will be possible?

Davis: In the same way that the administration went forward on steel, they are likely to do the same on autos and there will be retaliation from other countries. This will be the next step in the trade conflict, and this will heat up in September and October. Will there be a concession, and will the firms put the burden on consumers? In some ways they should, because the best way to stop trade wars is for consumers to realize that they are the ones who pay the cost of protectionism; a tariff is a tax. If we can get the public to realize that raising tariffs means raising taxes, you wouldn't see as much populist support for this tough talk on trade. I actually would like to see the automobile companies directly pass on the cost of the tariff to the consumer, and then consumers would have to express their concerns to their elected officials.

JS: The impact on global supply chains could involve so many countries and this would make the whole picture very complicated.

Davis: Doesn't this also neutralize the effect though, to the extent that all are going to face the tariff? It's interesting that General Motors and Ford have come out against the auto tariff because they have realized that they will also suffer from tariff retaliation and they also have companies overseas.

JS: This is how we will learn about the outcomes of globalization.

Davis: Yes. Let us hope we learn the right lessons!

JS

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