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Dealing with Donald Trump

By now, it should be clear that the US president has two objectives he wishes to achieve with his trade policy: first, to reduce the country's deficit in goods trade, and second, to contain the rise of China. The two goals are interlinked, as, in the president's view, the US bilateral deficit with China – which accounts (according to the US Bureau of Economic Analysis) for about half of the total US trade deficit in 2017 (811 billion USD) – implies a direct transfer of wealth from the US to China, weakening the first and strengthening the latter.

The US president seems to see the deficit as a blatant sign of weakness. Indeed, evidence suggests that competition with China has contributed to the decline of US manufacturing and has hurt many individual workers and their regions.[1] For Donald Trump, the US deficit in goods trade with the EU, worth 153 billion USD in 2017, is equally problematic. In a recent interview with Bloomberg, he said that, "Europe is as bad as China, just smaller."[2]

The US President's Trade Policy Agenda claims that US firms are treated unfairly in foreign countries while the US is open to foreign competition.[3] Foreign countries do not provide reciprocal market access to US producers; they unfairly subsidise their own firms; they do not respect intellectual property rights; and they manipulate their currencies. And all this has been enshrined in his predecessors' trade deals, which Donald Trump disqualifies as "disastrous", "worst ever", or "shameful". The situation may be repaired either if the foreign partners grant the same reciprocal access, or if the US restricts its own, e.g. by imposing high tariffs.

Negotiating like Donald Trump

The US President's 2017 Trade Policy Agenda sets out a new approach, which it repeatedly qualifies as "aggressive". This is certainly not an adjective that is often used in trade diplomacy. It illustrates the break with conventional protocol in which trade experts meet behind closed doors and exchange offers and counter-offers. They definitely also exchange threats. But now with this US president, all of this takes place in public. Most of the threats are tactical; the negotiators want to extract concessions from their counterparts and building up a credible threat is part of the tactic. However, by breaking protocol, the US President has gained substantial bargaining power, because he puts himself in a situation in which he actually has to implement his threats if the negotiation counterparts do not conform in order to save face on the domestic and global stages.

Another rupture of the conventional protocol relates to the nature of threats. In the past, when two parties, say the US and the EU negotiated, the choice that each party presented the other with was between the status quo, governed by the rules and tariffs agreed upon at the last round of multilateral negotiations (the Uruguay Round of 1986-1994) and a bilateral trade agreement that would, if successfully concluded, unlock some additional gains. Now the game is very different: if negotiations fail, the parties do not fall back to the status quo. Rather, in case of failure, Trump starts a trade war. Partners have to choose between the aggressive withdrawal of US concessions – never mind that they are guaranteed under international law – and some alternative which the president prefers but which could fall short of the status quo for the partner country. Trump has repeatedly insisted that he has no respect for the existing legal order. Just recently, he called the World Trade Organization (WTO) "the single worst trade deal ever made" and threatened, "If they don't shape up, I would withdraw from the WTO".[4] Similarly, he has threatened to cancel NAFTA, the North American Free Trade, if Canada and Mexico do not conform to his wishes. By ignoring the rules of established trade law, the US President has gained substantial bargaining power.

His approach works and fails

Exerting concessions from trade partners may very well work if these are vulnerable to US tariffs and too small or politically divided to credibly threaten retaliation. The US President has forced a revision of the US-Korea agreement, which makes Korea worse off relative to the status quo but better off relative to a situation in which it faces high tariffs in a key sector: steel. This is why Korea has agreed to relax

1 D. Autor, D. Dorn, G. Hanson: The China Syndrome: Local Labor Market Effects of Import Competition in the United States, in: American Economic Review, Vol. 103, No. 6, 2013, pp. 2121-68.
2 See Bloomberg: Trump Makes Clear EU Won't Escape His Ire Over Trade for Long, 31 August 2018, available at https://www.bloomberg.com/news/articles/2018-08-31/trump-makes-clear-eu-won-t-escape-his-ire-over-trade-for-long.
3 2017 Trade Policy Agenda of the President of the United States, available at https://ustr.gov/sites/default/files/files/reports/2017/AnnualReport/AnnualReport2017.pdf.
4 See Bloomberg, op. cit.

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safety standards on cars imported from the US and strict quotas on a long list of steel and aluminium products. For the same reason, the Mexican government seems willing to accept tougher rules of origin which make their car industry less competitive in the US market. With larger trade partners, who have the power to reciprocate the harm caused by US tariffs, such as the EU or China, the bullying does not work so well. Yet, it does succeed in bringing the countries to the negotiation table.

However, economically, the approach almost surely fails in the sense that it does not cure what the US President sees as one of his country's biggest problems: the trade deficit. Most economists view the current account as driven by differences between countries, monetary and fiscal policies as well as by slow-moving fundamental factors such as demographics or future productivity growth. Tariffs, in contrast, have little impact on the current account in particular in the presence of flexible exchange rates. This is not to say that US import tariffs cannot have welfare effects: they may, if well chosen, improve the country's terms of trade and hurt its trade partners, as the literature on optimal tariffs and trade wars shows.[5] But the trade deficit largely remains unchanged. This has an important corollary: unilateral concessions to the US by its trade partners will not reduce the trade deficit which the US President is so obsessed with.

Transatlantic trade disputes

Based on Section 232 of the 1962 Trade Expansion Act,[6] the US has imposed new tariffs on imports of steel and aluminium from the EU as of 1 June 2018. The US administration justifies those tariffs by triggering a provision in the WTO text which allows countries to withdraw commitments for national security reasons. As most EU members are NATO members, it is quite obvious that this justification is a provocation in itself. It is just another example of how the US President breaks the conventional protocol of international law. Article XXI of the General Agreement on Tariffs and Trade (GATT), which does allow the withdrawal of trade concessions when a country's national security is threatened, has been described as the "nuclear" option. The reason is that no international tribunal can refuse a sovereign country's right to define whether its national security is threatened or not.

5 For a relatively recent example, see G. Felbermayr, B. Jung, M. Larch: Optimal tariffs, retaliation, and the welfare loss from tariff wars in the Melitz model, in: Journal of International Economics, Vol. 89, No. 1, 2013, pp. 13-25.

6 Section 232 of the Trade Expansion Act of 1962 (19 U.S.C. §1862) authorises the Secretary of Commerce to conduct comprehensive investigations to determine the effects of imports of any article on the national security of the United States.

The EU has reacted by imposing compensating tariffs, claiming that the US tariffs are to be classified as safeguard tariffs based on GATT Article XIX and cannot be justified on national security grounds. Whether or not this legal position holds, imposing compensating tariffs is the right policy choice, for at least three good reasons. First, inaction or unilateral concessions do very little to reduce the US trade deficit, so that the President's claim that the US is taken advantage of is unlikely to lose its bite. If there is no counterreaction, further US aggression based on the very same argument – that the trade deficit jeopardises US security – is likely. Second, the reckless US policies endanger the multilateral system which is held together by the WTO – a toothless tiger. WTO courts cannot enforce their rulings; so trade law must be self-enforcing. This is achieved by the credible threat of a tit-for-tat strategy. Not reacting invites deviation from other trade partners as well. So paradoxically, if the EU wants to fence in the WTO it has to react, even if the compensating tariffs may themselves be illegal before WTO law. And finally, retaliation increases the economic and political costs of US non-cooperation, thereby strengthening the opponents of tariffs in American politics.

The Rose Garden truce

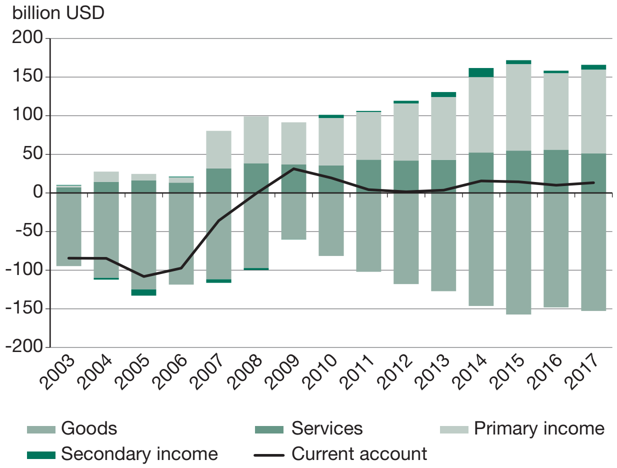
In May 2018, the US President ordered a new investigation into whether car imports threaten US national security. If yes, he could impose new tariffs on auto imports of 25% and this would cause substantial harm around the world, in particular in Germany.[7] The EU has reacted by proposing negotiations with the objective to eliminate all tariff and non-tariff barriers in manufacturing across the Atlantic. The summit between US President Trump and EU Commission President Juncker on 25 July 2018 in Washington resulted in a declaration which endorsed this objective. The partners agreed not to increase any tariffs during negotiations.

The summit statement, delivered in the Rose Garden of the White House, has surprised many. But it shows that the firm response of the EU (and other countries) to US tariffs pays off by making the US President's aggressive trade policy more costly to him and his political allies. It may also reflect the very simple fact that the bilateral current account position of the US with Europe is not imbalanced at all. Using data from the US Bureau of Economic Analysis, Felbermayr and Braml show that the American bilateral deficit in goods trade of 153 billion USD is more than compensated by a surplus in services trade of 51 billion USD and in investment income of 106 billion USD (Figure 1).[8]

7 At the ifo Institute we estimate the long-run GDP losses for Germany to amount to about five billion euro.

8 M. Braml, G. Felbermayr: Regionale Ungleichheit in Deutschland und der EU: Was sagen die Daten?, CESifo, ifo Schnelldienst, Vol. 7/2018, 12 April 2018.

Figure 1
The EU-US bilateral current account balance and its components



Note: Primary income includes returns to foreign direct investment and portfolio investment, as well as interest payments. Secondary income relates to transfers such as remittances by immigrants, development aid and payments to US soldiers in Europe among other things.

Source: Bureau of Economic Analysis, own illustration.

Embarrassing discrepancies in current account data

The bilateral EU-US current account has been in balance since 2008. The picture for the eurozone is similar. Embarrassingly, though, Eurostat statistics tell a very different story. They report a large current account surplus of the EU, putting the Union into a strategic disadvantage. Felbermayr and Braml argue that the aggregate EU statistics are not to be trusted, and that the discrepancies result from problematic treatment of investment income by EU countries with very generous patent boxes, such as Ireland or the Netherlands.[9] In any case, the Bureau of Economic Analysis and Eurostat cannot both be correct. Clarifying the facts should be a top priority for both the EU and the US. Before entering into trade negotiations or even a trade war, it is of absolutely crucial importance to chart out the territory.

But if the nature of transatlantic exchange is indeed quite balanced, as the US statistics suggest, the EU has ample scope for retaliatory action that would hurt the US service exports and multinationals operating in Europe. Such asymmetric retaliation, e.g., in the form of a digital sales tax directed against US digital firms, could directly bite into multinationals' profits as marginal costs of providing digital services are close to zero. The US President may not have much sympathy for the East and West coast elites that might suffer from such a policy, but he is surely impressed by their political clout. Indeed, democratic members of congress have, so far, staged very little resistance to the President's trade policy. But this is very likely to change if firms in their own constituencies become affected by European counter measures.

Whether a digital sales tax is in the economic interest of the EU is open for debate. But it is a powerful and credible threat. If things work out properly, such an asymmetric retaliation strategy remains off equilibrium, i.e. it has an important role in bringing the EU closer to its negotiating objectives, but it will not have to be triggered as the US adjust their strategy to avoid it.

There is more: if the transatlantic relationship is fairly balanced, the role of China in explaining the aggregate US current account deficit becomes even more evident. It is not surprising that the Rose Garden truce between Trump and Juncker also includes a statement to jointly address China's opportunistic behavior.

EU-US negotiations will be very difficult

Of course, a reduction of trade barriers across the Atlantic would be a very good idea, as the many quantitative studies on the Transatlantic Trade and Investment Partnership (TTIP; now on hold) have shown. But it would not per se lower the US trade deficit.

What is more, a TTIP light agreement restricted to industrial goods would create an asymmetric impact, benefitting EU countries with strong comparative advantage in manufacturing (such as Germany) more than the US. For an agreement to be balanced, it will have to include agriculture and services – key offensive interests for the US that are critical to some of Trump's support base. This is another lesson easily gleaned from the TTIP studies.

The EU's position – to give up asking the US to open its public procurement markets in exchange of excluding agriculture – is unlikely to satisfy the US. This may be the reason why the US President recently claimed that the EU's offer to eliminate car tariffs would not be enough. Moreover, the revised NAFTA agreement does include an important chapter on financial markets. The same interests that pushed for their inclusion would also push for putting finance onto the agenda in any transatlantic deal.

This may result in negotiations veering quickly into the troubled waters that have sunk EU-US trade negotiations under the Obama Administration. The US find it difficult politically to extend the opening of public procurement to the state and municipal level; the EU faces enormous political pressure to restrict agricultural imports and to open services markets, in

9 Ibid.

particular those in which public provision traditionally plays an important role. What is more, while the EU might benefit from pacifying its bilateral relationship with the US, such a deal does nothing to remedy the existential threat that Trump's Section 232 tariffs pose to the world trading system. It would undermine solidarity between the WTO members who are all affected by the US President's policies.

There is another potential complication: any bilateral agreement violates the most favored nation (MFN) principle of the WTO, which prohibits discriminating between different trade partners. Article XXIV of the GATT formulates an exemption for free trade agreements (FTAs), but requires that any free trade agreement must substantially cover all trade. So, excluding the food industry from an EU-US trade agreement can bring it into conflict with WTO law. However, at this juncture in history, beggars cannot be choosers. There is no real economic rationale for the requirement of Article XXIV: any liberalisation is better than none. Moreover, out of the many hundreds of trade agreements that have been concluded so far, many – if not most – provide for exemptions, the EU-Turkey customs union being a leading example. Finally, if the EU and the US manage to pacify their relations with the help of a bilateral agreement, the multilateral system is bound to benefit, too. One thing is absolutely certain: with the EU and the US at logger heads, there cannot be any progress in reinventing or redesigning the WTO.

The WTO must die to live

The multilateral system has been paralysed for a while. The Trump Administration is doing everything to quicken its demise; for example, refusing to confirm nominations of judges to the WTO's appellate body. But the problems of the system are very real. After the Uruguay Round, a situation emerged, in which countries such as the US have very low tariffs (the US median tariff being a mere 2.3%),[10] with emerging markets such as China imposing much higher tariffs. The key issue is that industrialised countries have little to offer in tariff negotiations. This blocks the usual mutual market access exchange. Moving negotiations into non-tariff barriers is one possibility to increase the scope of a deal, but this has proved to be very difficult politically. As a consequence, the multilateral process is stuck. Countries have turned to bilateral agreements instead.

Paradoxically, the US President's betrayal of the WTO protocol may help to move the world out of this stalemate. By credibly threatening to leave the WTO altogether, Trump dramatically improves his position. This could force emerging markets to make concessions. In the process, the WTO as we know it would probably be lethally damaged. The new medium-run world trading system would probably be shaped by large bilateral agreements between the US, the EU and China, with the latter two representing entire regions.

But technology will continue to lower trade barriers such as those imposed by geographical distance or even by language differences. The process of economic integration will continue, so that the costs of political non-cooperation go up. The logic for multilateral cooperation in trade and beyond becomes stronger, not weaker. A new governance forum will emerge, where negotiating will take place in country clubs instead of among members at the WTO. The EU is well equipped to play a leading role in this new forum. But EU leaders of today quickly need to explore the unchartered territory they have entered due to Trump's unconventional trade policy maneuvering.

10 G. Felbermayr: Zölle im transatlantischen Handel: Worauf, wie viel und wie gerecht?, in: ifo Schnelldienst, Vol. 71, No. 6, 2018, pp. 3-8.