

The New York Times

A Trade War Primer



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June 3, 2018

At the moment, the Trumpian trade war appears to be on. And I've been getting some questions from readers about how this is possible. Congress, after all, hasn't voted to back out of our trade agreements, and one suspects that it wouldn't even if Trump asked for such legislation: to all appearances, a lot of Republicans are pretty much OK with the near-certainty that he colluded with a hostile foreign power and is currently obstructing justice, but policy actions that might strand and devalue a lot of corporate assets are something else entirely.

So how does Trump have the authority to do this? And what are the consequences for the world? It seems to me that this might be a good time to write down a brief, non-scholarly primer on how the trading system – and U.S. trade policy within that system – work.

The key thing you need to understand about trade policy is that the Econ 101 case for free trade plays very little role in actual policy, certainly in trade negotiations. That's not because policymakers either reject that case or fail to understand it; some do, some don't, but either way it doesn't make that much difference. (In fairness, there's an academic literature arguing that the underlying economics matter more than I'm suggesting, work that I consider admirable but unpersuasive.)

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True, for the past 80 years the U.S. has sought to make trade gradually freer; this reflected in part the (very) indirect influence of economic theory, in part the belief that closer economic integration was good for peace and the free world alliance. But the process by which trade liberalization was sought was all about political realism rather than abstract ideals.

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And what political realism on trade means is that producer interests matter much more than consumer interests, because producers tend to be far more organized and aware of the stakes in any given trade policy. The classic case was sugar, where for many years U.S. import quotas kept prices here several times above world levels. The benefits of that policy went to a few thousand sugar growers, for each of whom it was worth tens or hundreds of thousands a year. The costs were thinly spread among tens of millions of consumers, the vast majority of whom had no idea there even was an import quota.

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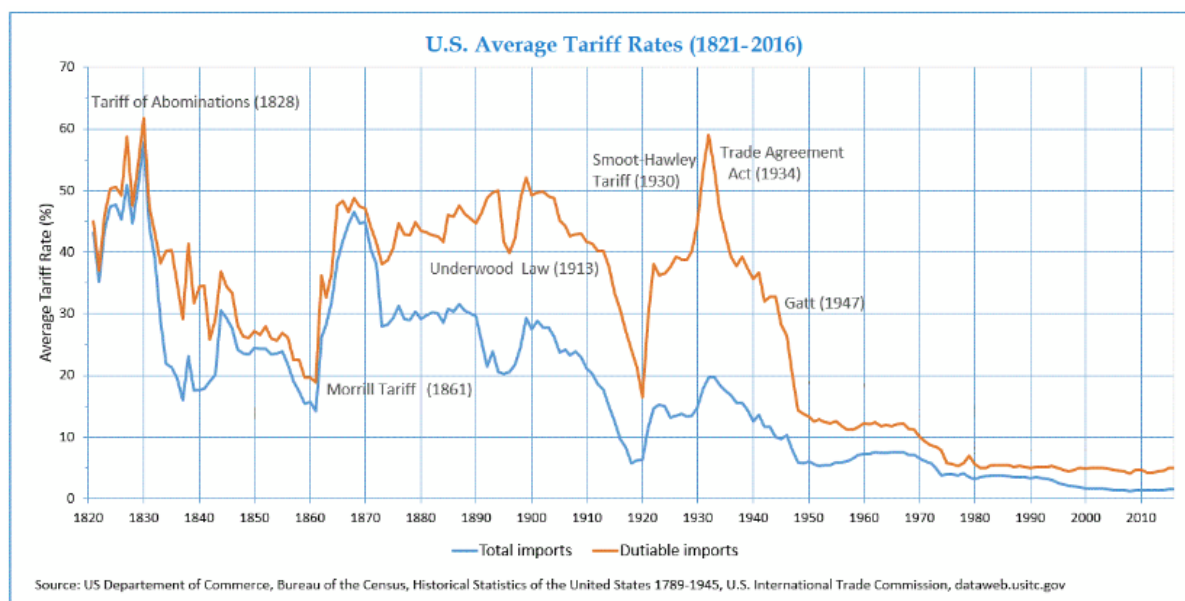
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Given this asymmetry in representation, you might expect the interests of import-competing industries to predominate in practically everything we could produce here, leading to high levels of protectionism. And that was in fact the way U.S. trade policy tended to work until the 1930s.

But then FDR introduced the Reciprocal Trade Agreements Act – a system, initially, of bilateral negotiations in which America would agree to reduce tariffs on foreign goods if foreign governments reduced tariffs on our goods. What this did was change the political calculus, by bringing the interests of export industries into the picture. U.S. firms competing with imports might still clamor for protection; but they would face the counterweight of U.S. exporters demanding deals that gave them access to foreign markets.

You could say that the RTAA was based on bad economics – that it embodied the mercantilist assumption that exports are good and imports are bad. But it was an enlightened form of mercantilism, creating a process that led to generally good economic outcomes.

For this process to work, Congress needed to step back from the details of trade policy; instead, it would allow the executive branch to negotiate deals, then vote those deals up or down. And the result, even before World War II, was a significant climb-down in tariff rates.



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Then, in 1947, the U.S. and its partners established the General Agreement on Tariffs and Trade, which basically created a multilateral version of the same system. I think of the GATT as a system of levers and ratchets. The levers – the mechanism used to make trade gradually freer – consisted of elaborate horse-trading negotiations (“rounds”) resulting in tariff reductions. The ratchets, preventing backsliding, consisted of rules preventing countries from going back on their previous commitments, except under certain conditions.

Why are there exceptions? Political realism, again. The creators of the trading system realized that it needed some flexibility – that too rigid a system of rules would end up being brittle and would shatter under the press of events. So countries were granted the right to impose new tariffs under the following conditions (real trade lawyers know that I’m oversimplifying, but the essence is right):

- Market disruption – a sudden surge of imports too fast for domestic producers to adjust to, in which case they could be given some breathing room
- National security – making sure you’re not dependent on potential enemies for crucial goods
- Unfair practices – tariffs to counter, say, subsidized exports
- Dumping – when foreign firms seem to be selling goods below cost in an attempt to establish market dominance

In the U.S., who determines when one of these justifications applies? Not Congress – that would just reopen the whole can of worms FDR closed in 1934. Instead, the executive branch is supposed to follow a quasi-judicial procedure, in which investigating agencies determine whether one of these conditions is met, then the president decides whether to take action.

But what if the U.S. takes action, but our trading partners don’t consider it justified? (Or, conversely, what if the U.S. objects to another country’s actions?) They can demand international arbitration, which was very cumbersome until the World Trade Organization was created in 1993, but now usually proceeds quite quickly.

Then what? Suppose the WTO finds that a country has acted inappropriately; what power does it have to enforce that judgment? Directly, none: there isn’t a fleet of black helicopters based in Geneva, ready to swoop down on trade miscreants. Instead, the WTO effectively declares the offending nation an outlaw, granting aggrieved trading partners the right to retaliate as they see fit.

And historically that threat has worked: countries that lose WTO cases generally back down and reverse their policies. Why did it work? Because everyone was aware that if things got out of hand, we could devolve into a tit-for-tat trade war that would undo 70 years of progress.

Which brings us to Trump.

The world trading system is actually a quite remarkable construction – a framework that has consistently produced a high level of global cooperation. It has been pretty robust in the face of even severe shocks – notably, the world did not see a major resurgence of protectionism after the 2008 financial crisis. But it was never designed to deal with a major world leader who has contempt for anything resembling the rule of law.

Past presidents have used their authority to impose tariffs, and not always for the best of reasons. Even Obama imposed a temporary “market disruption” tariff on Chinese tires. They have always, however, been circumspect: their tariff actions were limited, and the economic basis for their actions was at least vaguely defensible.

But Trump has gone ahead and imposed tariffs using the national security argument, in a context that makes no sense. There is no coherent argument about why imports of Canadian aluminum pose a national security threat; there will be even less justification if he does the same for autos. In fact, his administration is barely even trying to pretend that real national security concerns are at work. He’s just doing this because he can.

Worse, there’s no obvious end game. What can the Chinese, let alone the Europeans and the Canadians, offer that would satisfy him? An end to U.S. trade deficits? That’s not something trade policy can or should deliver.

And of course everyone else in the world is furious with the U.S.. This matters, because trade policy is inherently political; even if giving Trump big concessions were good economics, which is far from clear, our democratic allies – former allies? – are going to be in no mood to go along.

So now you know why Trump has the power to do what he’s doing, and why it’s such a big, bad deal.

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