13 Trade under T.R.U.M.P. policies

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International trade was a focal issue in the 2016 US Presidential election. Candidate Trump recognised the discontent of certain struggling US workers and amplified their view that international trade (and immigration) is the source of their problems. The president's trade agenda promises a new approach to trade policy that will 'expand trade in a way that is freer and fairer for all Americans.' We broadly support this general objective, especially if it means policies that expand trade and generate aggregate welfare gains, while ensuring those that bear major costs are compensated. Unfortunately, the current approach threatens to significantly *reduce* US trade, without specifying how it will fundamentally address redistribution.

We start by describing the administration's plans to address 'unfair foreign trade practices' via unilateral policies, renegotiation or withdrawal from agreements, and threats of import protection. We argue this overall approach of **T**emporary, **R**eversible, **U**ncertain **M**FN and **P**referential policies – **T.R.U.M.P.** policies – is generating a trade cold war that increases uncertainty and threatens the world trading system. We then draw on recent research that identifies how T.R.U.M.P. policies reduce trade related investments and quantifies the resulting contractions in exports and increases in consumer prices. We conclude by discussing how T.R.U.M.P. policies can be mitigated and some of the more disastrous outcomes avoided.

1 Kyle Handley acknowledges financial support from the NSF under grant SES-1360738. Nuno Limão acknowledges financial support from the NSF under grant SES-1360780.

T.R.U.M.P. policies

Candidate Trump threatened to reverse commitments under long-standing trade agreements and substantially increase US import barriers. Specific threats included (1) withdrawing from the Trans Pacific Partnership (TPP); (2) renegotiating NAFTA 'to get a much better deal', or otherwise withdrawing; and (3) labelling China as a currency manipulator. More generally, he promised to 'identify every violation of trade agreements a foreign country is currently using to harm our workers (…) and use every tool under American and international law to end these abuses.' He also threatened to impose a 35% tariff on Mexican auto part imports and a 45% tariff on all Chinese imports, 'if they don't behave.' Moreover, he stated that if these policies were challenged in the WTO 'Then we're going to renegotiate or we're going to pull out (…) The World Trade Organization is a disaster.'

Some threats are Trump's version of the standard tough talk on trade employed by prior presidential candidates;[2] however, we should not dismiss them as electoral pandering. While specific threats may not be pursued by this administration, its overall approach can seriously damage the credibility of the world trading system for years. Two factors indicate this is a distinct possibility. First, there is a wave of populist and nationalist sentiment that blames many of the economic problems facing working and middle class labour on international trade and immigration. Second, the multiple threats during the campaign had a unifying principle: the 'system is rigged and the US must fight back'. This view is articulated in the campaign's economic plan that argues the US trade deficits are the outcome of 'unfair trade practices', where 'China is hardly the only cheater in the world; it's just the biggest'.[3]

2 Past presidential candidates have promised to: (1) withdraw from the TPP (Hillary Clinton); (2) renegotiate/amend Nafta (Hillary Clinton, Barack Obama) (3) label China a currency manipulator (Mitt Romney); (4) enforce rules in trade agreements and use 'tougher negotiators' (Barack Obama); (5) Revoke China's MFN status due to human rights violations, implying US tariffs of about 35% (Bill Clinton).

3 Senior advisors Peter Navarro and Ross Wilbur claim 'the use of illegal export subsidies, the theft of intellectual property, (…) currency manipulation, forced technology transfers and a widespread reliance upon both "sweat shop" labor and pollution havens', P. 16 Scoring the Trump Economic Plan: Trade, Regulatory, & Energy Policy Impacts.

While particular concerns may be valid and have been raised by other candidates, some of the remedies and methods proposed to address them are worrisome and generated considerable uncertainty even during the race. First, among foreign firms, 'about 50% of European CFOs say that a Trump win would cause them to hold off on investment until uncertainty about his presidency is resolved, compared to fewer than 10% if Clinton wins.' Second, a US news based index of Trade Policy Uncertainty (TPU) has substantially increased since Trump's candidacy announcement. As shown in Figure 1, the fraction of newspaper articles about international trade and trade policy that also mention 'uncertain' or 'uncertainty' continued to increase after Trump secured the nomination, and won the election and now stands at its highest level in a decade.[4]

The early signs of the willingness to pursue this approach include: **(1) The team.** The appointment of Wilbur Ross as Commerce Secretary and Peter Navarro as head of the newly created National Trade Council – the co-authors of the aforementioned economic plan. **(2) The agenda.** The "2017 Trade Policy Agenda" reflects the key issues in the campaign. It claims popular support for a new approach and promises that '(…) the guiding principle behind all of our actions in this key area will be to expand trade in a way that is freer and fairer for all Americans.' It warns that its '(…) goals can be best accomplished by focusing on bilateral negotiations rather than multilateral negotiations – and by renegotiating and revising trade agreements when our goals are not being met.' **(3) The actions.** These include the orders to (i) withdraw from TPP; (ii) identify countries with which the US had bilateral trade deficits along with their causes and consequences, including for national security, (iii) strengthen the enforcement of laws requiring the US government to favour American made products, and (iv) start the renegotiation process for NAFTA.

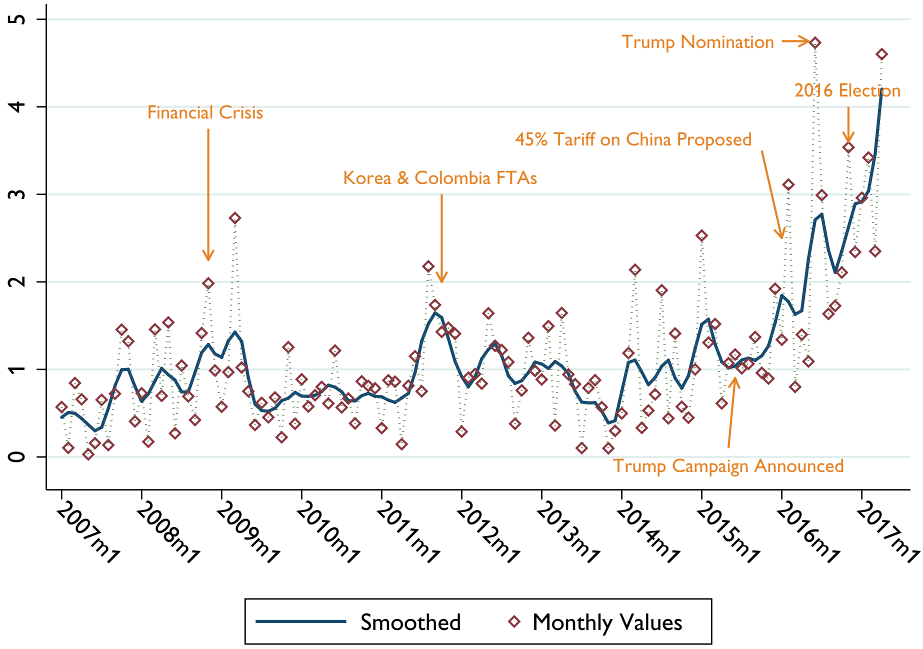
The probability of substantial executive trade policy changes depends on international and domestic legal constraints. Executive power is nearly unlimited when it comes to national security.[5]

4 The index applies the basic methodology in Baker *et al.* (2016) who, instead of trade policy, focus on domestic policy uncertainty and show it is associated with lower economic activity.

5 These include the "1917 Trading with the Enemy Act" and the "1977 International Emergency Economic Powers Act". The application under these Acts requires a war and/or emergency, and may thus be challenged in US courts. Those requirements are not necessary for the President to invoke the Trade Expansion Act of 1962 (art. 232) that allows restrictions on imports that affect national security. The GATT/WTO also allows for national security exceptions and no country has ever successfully challenged these.

Moreover, under the "1974 Trade Act" (section 122) the executive has the authority to impose temporary tariffs and quantitative restrictions to address balance-of-payments deficits. Thus, the prominent references to national security and deficits in the trade agenda and recent executive orders increase the likelihood that the administration could fend off domestic legal challenges to import protection; this further increases the current credibility of such threats.

Figure 1. US trade policy uncertainty news index, 2007-2017



International trade law also imposes constraints; but this administration appears willing to ignore them or renegotiate the agreements. The agenda lays out plans to enforce rules against foreign dumping and subsidies, in a way consistent with GATT/WTO rules, but also to use section 301 of the 1974 Trade act 'to take appropriate action in response to foreign actions that violate an international trade agreement or are unjustifiable, or unreasonable or discriminatory' (Agenda 2017 p.3). Section 301 has not been invoked since the creation of the WTO and would likely be challenged. This does not decrease the credibility of current threats if, as the trade agenda suggests (p.3), any negative WTO rulings are ignored.

In fact, in Congressional testimony on the costs and remedies open to the US after China's entry into the WTO, nominee for USTR, Robert Lighthizer, argued that the US should consider 'derogation from WTO stipulations if it is in its national interest' even if it leads to retaliation by other countries. Such derogation and retaliation in the context of broad issues such as the proposed border adjustment tax – that may generate the largest ever authorised retaliation (Bown 2017) – might lead to the demise of the WTO. In sum, there is a credible threat of an increase in US import protection either unilaterally, by renegotiating prior policies, or as a consequence of a trade war.

One of the stated objectives of PTAs is to 'ensure a predictable environment for business planning and investment'. That predictability is threatened by the real possibility that the US, like Britain, will terminate its agreements with one or more of 20 different countries. The president can withdraw from PTAs by simply providing a six-month written notice (cf. Art. 22 of NAFTA).

Even if NAFTA and other PTAs survive, their predictability will be severely undermined in the short- and long-run. First, there is little guidance on the parameters of renegotiation other than 'to get a better and fairer deal' for the United States. Outright withdrawal would eventually lead the US to re-impose MFN barriers on its former PTA partners.[6] US MFN tariffs are not high on average, but that does not mean withdrawing from the PTA would have small trade effects. These agreements also target a variety of barriers and reduce uncertainty substantially; both of which are important factors in explaining the large increase in bilateral trade caused by PTAs (Limão 2016). Second, the long-run prospects are also uncertain under one of the key objectives of the administration of: 'Updating current trade agreements as necessary to reflect changing times and market conditions' (Agenda, 2017 p.2). Such contingencies, for example linking policy changes to trade deficits, would make trade agreements more complex and uncertain as we discuss further below.

In addition to the general TPU increases reflected in the index in Figure 1, there is also specific evidence that the trade agenda changed investor expectations. A March 2017 CNBC survey found that 95% of global CFOs are concerned that the new administration will provoke a trade war with China and about 17.5% consider US trade policy to be the 'biggest external risk factor' facing their business, a risk second only to consumer demand.

6 The President may require additional authority from Congress to revert to those policy levels.

A majority of US CFOs surveyed in this period by Duke University also believe that specific policies such as a 'substantial tariff on Chinese and Mexican goods' would be bad for the US economy.[7] In sum, both the reactions of business leaders and of the media strongly suggest TPU has increased, which we now show can have economic consequences even before any policies are implemented.

Economic consequences of T.R.U.M.P. policies

Recent research shows the large potential costs related to trade under T.R.U.M.P. policies. Our focus is not on the impacts under a hypothetical trade war, but rather those under the ongoing trade cold war initiated by Trump, which is characterised by a higher *probability* of abandoning/renegotiating agreements and entering a 'hot' trade war.[8]

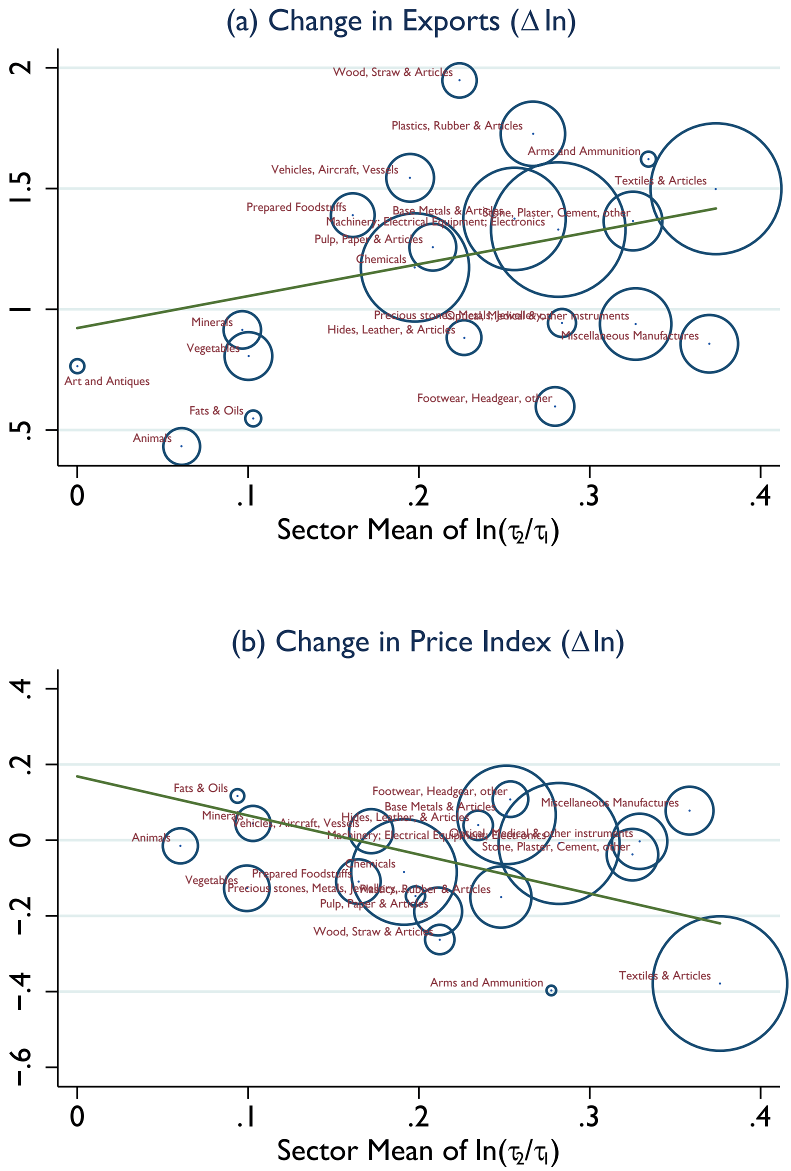
Trade cold war: US policy uncertainty, imports and consumer welfare

In the 1990's the US congress voted annually on whether to revoke China's MFN status and thus impose tariffs of over 30%. The current trade cold war shares a key feature with that period: threatening substantial tariffs if China does not behave. Handley and Limão (forthcoming) find the earlier cold war substantially reduced imports and increased consumer prices of US imports from China. They estimate the differential impacts across industries of eliminating that threat after China's 2001 WTO accession. The basic relationship is clear in their figure 2 (below). It shows that industries facing higher potential tariff increases in the US in 2000 (x-axis) had substantially larger import growth and price reductions. After controlling for other factors, they conclude that the uncertainty reduction accounted for about a third of the import growth and lowered their price for the US consumer by over 15% in 2000-2005.

7 These concerns are shared at similar rates by the subset of CFOS of US manufacturing firms, which calls into question the administration's belief that these policies would help them.

8 Noland *et al*. (2016) find large impacts on the US economy if it ever started a trade war, defined as a substantial increase in US tariffs and possibly foreign retaliation.

Figure 2. Chinese export and price index change vs. initial uncertainty level.



Notes: Reproduced from Handley and Limão (Forthcoming, Fig. 2). Simple means within sector of export and price index change vs means of initial uncertainty measured by $\ln(\tau 2V / \tau 1V)$ where $\tau 2V$ is the column 2 threat tariff, i.e. Smoot-Hawley era, and $\tau 1V$ is the MFN tariff in 2000. Circles are proportional to the number of observations used as weights in the linear fit represented.

Thus, even though the probability of escalation during the trade cold war of the 1990s was low, the economic effects from the threat of war were large; the effective price increases for US consumers were equivalent to a permanent 13 percentage point tariff increase. Re-kindling those threats in 2017 will have even larger costs for US consumers as the share of Chinese goods' consumption is higher.[9]

The current administration's threat to renegotiate and willingness to withdraw from *all* its agreements will be even costlier to US consumers. Consider a simple experiment: a modest US increase in the probability of high protection, similar to that which China faced but against all its partners. Handley and Limão (Forthcoming) compare the welfare cost to US consumers of this TPU and show it is about one third of the cost they would face if the US closed its borders to all trade.

Trade cold war: Reciprocal policy uncertainty and US exports

The proposed approach to PTAs is also likely to reduce US gains from these agreements and lower its exports. Renegotiating PTAs risks turning them into temporary reversible preferences, similar, for example, to those the US once granted to Peru and Colombia. These uncertain preferences fail to generate substantial trade (cf. Limão, 2016) and export entry investments (Handley and Limão 2015), which is a key reason why Peru and Colombia sought permanent PTAs with the US in exchange for lowered barriers to US exporters. Even if 'tough US negotiators' got a 'fairer share' of the overall gains from PTAs those gains would be lower and US exporters' market access would be likely to be reduced under new or renegotiated temporary PTAs.

The insurance value of PTAs and the cost to US exporters of foreign uncertainty can be particularly important during periods of economic crisis. Downturns tend to increase import protection (Bown and Crowley 2013) – the starkest example was the Great Depression, which triggered a trade war in the 1930s. The Great Recession and associated global trade collapse increased TPU, as seen in Figure 1, and the risk of a trade war.

9 The higher prices would increase the supply and employment of non-Chinese firms to the US market, but many of those firms in 2017 will no longer be in the US, so there is limited potential for this new trade cold war against China to restore many of the manufacturing jobs lost when TPU was reduced in 2001.

Fortunately, history did not repeat itself. An important difference relative to the Depression was the large network of credible trade agreements. These include PTAs and the GATT/WTO, which was created in 1948, following a period of high TPU, in part to avoid repeating the 1930s (Limão and Maggi 2015). Under T.R.U.M.P. policies and in the wake of Brexit there is a higher probability that a large economic crisis will trigger a trade war.

Carballo *et al.* (2015) show that PTAs provided US exporters with some insurance during the great recession. They find substantial exit of US exporting firms from non-PTA markets where economic uncertainty was higher; moreover, that effect was magnified in industries where the threat of tariff protection was also higher and substantially smaller in PTA markets.

Reopening any agreement would replace a system built on long term policy commitments with a regime where commitments change with the preferences of each newly elected government. The latter would ensure an *unpredictable* environment for business and investment and end US reciprocal PTAs as we know them. Renegotiating PTAs to include snap renegotiation triggers for deviations from trade deficit targets and 30-day termination rules, would explicitly increase interactions between policy and adverse economic shocks and lower their insurance value. Moreover, if the administration carries out threats to ignore adverse WTO rulings or withdraw, then US exporters may expect to face tariffs much higher than the current bound rate commitments, which have been shown to effectively increase exports (cf. Handley 2014). In short, US trading partners will reciprocate T.R.U.M.P. policies and their policy uncertainty will hamper the administrations' key objective of expanding US exports and associated employment.

Mitigating T.R.U.M.P. policies

Some of the consequences of T.R.U.M.P. policies may already be under way. However, their full effects, if left unchecked, will take a few years, as firms allow their investments in exporting to depreciate. This slow process may mask the cost of the policies (unless there is a trade war or economic crisis) but also opens up the possibility that they can be mitigated. We conclude with suggestions on how the administration, Congress and other agents could achieve this and move closer to the objective of 'freer and fairer trade'.

The administration could lower uncertainty in the following ways. First, it should recognise the historical value of the current trading system and indicate a willingness to abide by the basic principles of cooperation and reciprocity. Enforcing and renegotiating specific aspects of these agreements will be more successful if other countries believe the US will abide by them instead of labelling them as ‘a disaster’ and their members as ‘cheaters’. Second, it should announce which PTAs and clauses will be renegotiated; recognise much of their value stems from reducing policy uncertainty; and abandon proposals of 30-day termination periods and bilateral deficits induced renegotiations.

The US congress can also mitigate the impact of T.R.U.M.P. policies. The Constitution gives Congress the power ‘to regulate commerce with foreign nations’ (Art. I). While some of that power has been delegated to the executive (cf. Hufbauer 2016), Congress can vow to reclaim it if the executive uses it in a wholly new context or abuses it. For example, exiting PTAs rather than entering them or invoking the “1917 Trading with the Enemy Act” or the “1977 International Emergency Economic Powers Act” in the absence of a real war or emergency.[10] Large unilateral policies such as the border adjustment tax can trigger a trade war in the current environment and Congress should seek to avoid such an outcome (cf. Bown 2017).[11]

Other governments also have an important role to play. First, to re-commit to existing agreements between themselves. Second, to resist ‘new and better’ deals with the US, if they amount to temporary preferences conditional on arbitrary requirements. Third, to recognise that there are legitimate concerns with current agreements that need to be addressed, which include the secrecy of negotiations and the disproportionate influence of corporations over them

10 Those requirements are not necessary for the President to invoke the trade expansion Act of 1962 (art. 232) that allows restrictions on imports that affect national security.

11 US firms, workers and consumers (perhaps represented by states) can also vow to oppose any future extreme unilateral measures through preliminary court injunctions if they were ever ordered — the travel ban provides a recent precedent.

If the US administration is truly motivated to improve the outcomes of trade agreements for US workers then it should expand its trade agenda. First, by clarifying how workers will be represented in future negotiations. Second, by recognising that trade, like technological change, will always generate some losers and that the best way to address this is via a comprehensive social safety net, expanded access to education and job retraining, and incentives to increase geographic mobility.

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