EconoFact Chats: The Broader Impact of Trade Restrictions in the U.S.

Chad Bown, Peterson Institute for International Economics

Published on 12th February 2023

Michael Klein:
I'm Michael Klein, executive editor of EconoFact, a nonpartisan web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:
The Nobel laureate Paul Samuelson, when asked to come up with one economic idea that was both important and not obvious, cited comparative advantage; the idea that nations can benefit from international trade, even if they can produce everything more efficiently, or everything less efficiently than their trading partners. While the idea that nations gain from trade is one of the oldest and most durable economic insights, recently there has been movement away from free trade policies, both in the United States and in other countries. Are there reasons to restrict trade, for example, to boost national production of essential goods like semiconductors, or personal protection equipment, or for national security? Or will these efforts to limit international trade make for a poorer and more vulnerable world?

To discuss these issues, I am very pleased to welcome back to EconoFact Chats Chad Brown of the Peterson Institute for International Economics. Chad is widely recognized as an expert on international trade and he is one of the most cited economists in the popular press on this issue. He also co-hosts a terrific podcast series about the economics of international trade policy called Trade Talks. Chad has served as a senior economist for international trade and investment in the White House on the Council of Economic Advisors, and he's been a lead economist at the World Bank. Chad, welcome back to EconoFact Chats.

Chad Brown:
Thanks, Michael.

Michael Klein:
Chad, you were recently quoted as saying that this is the most exciting, contentious, uncertain time when it comes to trade policy in your lifetime. Why is that?

Chad Brown:
What I focus on in my research is less the question of why countries trade and what they trade, and rather whether they get along in trade policy. Do they cooperate? Have trade agreements? Or do they fight, have trade wars, and trade disputes? For most of my life, it's been a period of cooperation. Here in the United States where we live, we never quite got all the way to free trade, but we got pretty close, and certainly very, very close in historical terms. But today is just different and we've got conflicts coming up all over the place. There's the obvious trade conflict that the United States has had over the last four or five years with China, the trade war, but also, there are signs of potential conflict with other major trading partners like the European Union.
It's not just tariffs or import taxes that they're fighting over. It's now things like export control policies, limits on what you can sell to other countries, or subsidies. It's not any single product, either. It ranges from agriculture to things you mentioned like personal protective equipment, semiconductors, and electric vehicles. The reasons why they're fighting are oftentimes different as well. Sometimes it might be about domestic politics, domestic insecurity, or economic security. Maybe it's about health, maybe it's about resilience and something like that. What does that even mean? But now, we're also increasingly, I think, seeing signs that it may be spilling over into areas of national security, and military concerns as well, so I think definitely in my lifetime, and probably since the 1930s, there's never been a more contentious time in international trade.

Michael Klein:
Since the 1930s, but for full information, Chad, you're not 80 years old.

Chad Brown:
No, since the early 1970s, I guess, since I've been around, but I think I would extend that back even if I were 80 years old.

Michael Klein:
Well, you're much younger than that! The policy fights that you're referring to come from the view that trade is a zero-sum activity. Any gains to one group are offset by losses to another. But economists like Paul Samuelson don't believe this to be the case. Chad, is trade a zero-sum activity?

Chad Brown:
No, definitely not. At the aggregate level, trade for any country is a winner. And with any two countries, trade is going to be a win-win. The way I think we as economists like to think about it is to imagine the economy as being like a pie. Without trade, it's a certain size. It's a relatively small pie. When you open up to trade, that improves economic efficiency and resources within the economy. People switch jobs and do different things. They get put to better use. What ends up happening is the pie gets bigger. It gets bigger for the United States economy, it gets bigger for the European economy. It gets bigger for the Chinese economy. This is the standard story in international economics that we teach of the benefits of trade, comparative advantage, specialization, and things like that.

Michael Klein:
But nonetheless, Chad, there are winners and losers from trade, and even if there are net gains for a country as a whole, the losers are typically not compensated.

Chad Brown:
That's exactly right. Going back to the pie example with trade, the United States economy, we get a bigger pie overall, than we had before, but not everyone gets a bigger piece of that pie. There will be some companies and some workers at those companies that will get a much bigger piece of the pie than they had before. But there will be some who not only don't get a bigger piece of pie, their piece of pie is actually going to shrink. They get less than they did before.

Part of that is because they now face competition. Whether you're a company that used to be shielded from competition when there was no trade, now you open up to trade, and you face other companies out there in the world that are making the same thing that you do, and implicitly, their workers as well. This can introduce that new competition. Workers with smaller pieces of the pie, and in a lot of countries, we don't have the ability, or we don't redistribute -- take some of the bigger pieces of the pie away from the
real winners, and make everybody better off. That's the kind of thing we don't typically do, even though we could.

Michael Klein:
In fact, we don't do it for trade, but we don't do it for other things either, right? For automation, or the advent of computers, it's making some people better off, and some people worse off. It's probably good for the economy as a whole, but we don't compensate people who, for example, used to run television repair shops, which don't exist anymore. It's not just trade, but in a dynamic economy, lots of things are not compensated.

Chad Brown:
That's exactly right.

Michael Klein:
This complaint about international trade is based on the perception that it hurts people, or at least certain groups of people, but the current administration, they have another source of concern as well. In January, President Biden tweeted that 2023 would be the year of buying American, and two of his signature legislative achievements, the CHIPS Act and the Inflation Reduction Act, include policies promoting the production of American goods, or subsidizing the consumption of goods made in America. The CHIPS Act and the Inflation Reduction Act represent certain types of what economists call "industrial policies," where the government promotes certain industries. What does economic theory and economic experience teach us about the costs and benefits of industrial policies, Chad?

Chad Brown:
The first thing that economic theory teaches us about industrial policy is it's complicated, and so if we start off at Econ 101 teaching and we have competitive markets, perfect competition, lots of companies running around, no one has market power, there's no market failure, so there's nothing wrong, then there really is no role for governments to intervene or to subsidize. They can't really do any better for the economy than the market would be able to do. All they can do is screw things up. That's what basic economics teaches us. But I think the issue today is a lot of the action that we're seeing on industrial policy in the real world doesn't really fit that basic Econ 101 model. Once you allow for the world to be more complicated, you can get different outcomes.

Michael Klein:
What are some of the complications that would give you different outcomes that would diverge from the very simplest ideas about this?

Chad Brown:
One complication is if markets are pretty concentrated, so there are only a couple of dominant players in the market. You could imagine this to be the case in semiconductors maybe, perhaps electric vehicles maybe, but the point is they're not perfectly competitive. There are relatively few players. Then what can happen is subsidies can give companies in countries a competitive advantage. If you get there first, you can get a first-mover advantage. You can get more of the overall market than would otherwise be the case, and so the argument is if some countries are subsidizing already, maybe doing industrial policy is a rational response. In these kinds of industries, that's what we're seeing, so it's not as if the United States is the first one to subsidize semiconductors, it's kind of the last one to subsidize semiconductors. We have a lot of countries in Asia that have been subsidizing semiconductors for years. Similar to electric vehicles, China has been subsidizing electric vehicles.
Another example, and I think this is really important for the electric vehicles in the Inflation Reduction Act, is subsidies can actually be extraordinarily beneficial if there are what economists call "positive externalities" associated with them. So if there's something that the market doesn't capture. Here the argument is something like, "Well, there are some benefits, or distortions that could get corrected, by subsidizing these cleaner technologies, inducing consumers, for example, to switch over toward electric vehicles, and away from internal combustion engine types of vehicles, that they wouldn't otherwise have an intent to switch over to, because that's better for the climate.” When you have a big environmental concern out there, like climate, some of these industrial policy incentives can be useful for the economy as well.

Michael Klein:

As to your first point, Chad, if all countries are trying to be the first mover, doesn't that just create a lot of waste?

Chad Brown:

It can. You can end up with an outcome where there's too much subsidization. I think that's absolutely the case. Whether or not that's going to happen this time around, we'll see. I think another argument for some of these subsidies that I didn't mention, but that I should add, is the world that existed, say, before the pandemic, before all of the recent trade conflicts especially, was pretty economically efficient. We had very efficient supply chains. We had a location of semiconductor production especially, throughout the world that was very, very profitable for the companies, good for the economy, but it wasn't particularly resilient in the idea being that a lot of the concentration of production was located geographically in very, very few locations. Places like Taiwan and South Korea are the only places in the world that produce, for example, the fanciest high-end semiconductors.

That may have been okay in a world of 10 or 20 years ago. But the world that we live in today is quite different. It has to contest climate-related shocks, really severe storms, droughts, floods, and things like that. We now actually have health-related shocks with pandemics that can go shut down an entire location if there's a disease outbreak. Let alone, you could add in increased tensions associated with geopolitics. The idea of having really, really concentrated geographically production of certain really important types of economic activities like high-end semiconductors for the global economy is just a bad idea, so the argument is we need more diversification, and I think some of the subsidies that are happening out here, it's not only the United States, Japan is doing some, too, Europe is doing some, too, have that objective in mind.

Michael Klein:

You're speaking to the issue of national security, maybe writ large because you could talk about things like personal protection equipment in the event of another pandemic, or the production of semiconductors, which are very important for a wide range of things, including military applications. Should the government foster domestic production of these vital goods that have national security implications?

Chad Brown:

This is another one of these questions that it's complicated and I think you have to look at on a case-by-case basis. Part of what we now have to do though, since policymakers are motivating this, is to say, "Well, okay, what is the national security risk threat? What's the probability that something bad could happen when it comes to national security? Then what are the associated costs of that that would then motivate this kind of policy?" We used to didn't have to think all that hard about that, but recently, for example, with Russia's invasion of Ukraine, Europe realized the hard way that it had been excessively
dependent on Russia as its source of energy, natural gas through pipelines, and the same with oil. Russia threatened to cut it off, and has ultimately cut it off. The European Union has decided to cut itself off and look for alternative sources. But that has been extremely costly for the European economy, and so now, you have countries like the United States saying, "We don't want to have those same sorts of dependencies build up in certain areas where we might face national security threats."

Michael Klein:
You're raising the issue of national security in the context of the war in Ukraine and Russia's invasion, but a subtext to a lot of the discussion is the rise of China. There are concerns that Chinese high-tech products may be used to spy on US citizens and that the export of semiconductors to China are vital for its own military. Do you see the rise of China as an important source of trade tensions and how valid do you see these concerns?

Chad Brown:
I see nearly every trade tension that exists out there, especially for the United States, maybe less so for other countries, but certainly for the United States, almost every trade tension can be traced back to China in one way or another. That doesn't necessarily mean they're all legitimate, but they, I think, can all be traced back to China.

For the electric vehicle example, this is arguably the transportation of the future, and the concern there is that the current supply chain for a lot of the critical inputs that go into making successful electric vehicles, so the batteries, their raw materials, their components, well, currently a huge percent of those supply chains go through China. I think the United States' concern is that could lead to the same sort of dependence that Europe had with respect to Russia and you don't want to be as exposed. I think that's arguably one of the motivations for some of its industrial policy is to try to reduce that dependence is the concern over national security issues with a country like China.

Michael Klein:
In the wake of World War II, the United States was largely responsible for creating a rules-based international trading system. Are these policies by the United States but also by other countries reversing that?

Chad Brown:
Yes. I think it's clearly the case nowadays that the United States and other countries are imposing policies that are broadly inconsistent with the rules of the game that we've had since the end of World War II, as you mentioned. That's just sort of the new reality. Some would argue that, "Well, even when China came into the WTO in 2001, in the 20 years since then, it never really played by the same WTO rules as everyone else. It has a very different economic system that doesn't really fit within the WTO rules."

I think what we're seeing today is the concerns with how the global economy has evolved over the last 20 years through, again, very good, for the most part, trade policies, low tariffs, but it's led to economic efficiency, and in certain cases, the geographic concentration of certain types of economic activity, whether it's semiconductors, whether it's batteries for electric vehicles that are very, very concentrated geographically. The only way to change that is through policies that are probably breaking WTO rules because they ultimately are discriminatory. That's a key, key rule of the WTO, non-discrimination.
Michael Klein:

I think most of our listeners will know that the WTO is the acronym for the World Trade Organization and the WTO is a key institution for the rules-based trading system. But it's been hobbled lately, not least by the United States. Some of this occurred under the Trump administration, but the Biden administration has been slow to remedy the problem, right?

Chad Brown:

That's exactly right. The Trump administration imposed a lot of policies that in and of themselves were inconsistent with the World Trade Organization's rules. They hindered the dispute settlement process under the WTO. If a country has a trade dispute with another one, there's a process there to resolve the dispute. Well, the Trump administration refused to appoint judges to what's called its "appellate body," the WTO's appellate body, which means that it's really hard to now adjudicate grievances between countries, so that's weaker than it used to be. The Biden administration hasn't fixed any of those problems, and it's arguably through some of these industrial policies, introduced some of its own policies that are now probably not aligned with WTO rules.

But it's not just the United States. When the Trump administration imposed its policies, trading partners, if you don't like them, you're supposed to just file WTO disputes. That generally wasn't the reaction. They retaliated. When the Trump administration put tariffs on China, China retaliated with tariffs rather than waiting for a WTO ruling. When the Trump administration put tariffs on steel and aluminum, trading partners retaliated. China, but also Canada, and the European Union, so the WTO has found itself in a difficult position for a number of years, and there aren't really any signs that things are likely to get better for it anytime soon.

Michael Klein:

Chad, we've been talking at a pretty high level. We've been talking about the WTO, about nations as a whole, and so on. Can you talk a little bit about how these seemingly high-level events, industrial policy, the WTO, the violation of trading rules, how do these impact people at an individual level?

Chad Brown:

Well, I like to use the electric vehicle example. In the United States, through this thing called the Inflation Reduction Act, which was the piece of industrial policy legislation that passed Congress and was signed into law last summer in August of 2022, there are consumer tax credits in there for electric vehicles, so now, I can go to a car dealership, and it's cheaper for me as an individual to buy an electric vehicle today than it was before August 16th when this law went into effect. The purpose of that is to try to incentivize me to buy an electric vehicle, which is going to be better for the environment than one with a gas-guzzling engine. That's the first part. That's the good part of the Inflation Reduction Act.

The second and more troubling part is that electric vehicle only qualifies for that tax credit if it's assembled somewhere in North America, so if it's assembled in the United States, Canada, or Mexico. That's potentially good for American workers if there's enough of these electric vehicles being manufactured here in the United States. But if I wanted an electric vehicle that had been put together in South Korea because I really like the Hyundai IONIQ, or a Volkswagen, the ID.4, and the plant in Tennessee hadn't been up and running yet, and it was only available from the plant in Germany, or somewhere in Europe, I wouldn't be able to access that tax credit under the current rules. These things do affect individuals. How the rules of the game, the rules of these policies are ultimately written do ultimately trickle down. Their details really matter in terms of how they affect you and me.
Michael Klein:
It's really dangerous to predict what's going to happen, and people often don't want to do that, but I'll put you on the spot, anyway. What do you see happening to the international trading regime? Is there going to be this continued move towards nationalistic policies and industrial policies? What would you recommend countries do as we move forward?

Chad Brown:
I really think what happens depends less on trade and economic policymakers than on national security policymakers. We really can only do what they allow us to do, so if the United States and China decide they can't get along as countries, that they're for some reason going to be military adversaries, then the trading relationship is going to be very, very difficult, and it's going to be hard to have any kind of negotiations to come up with new trade rules that would accommodate our getting along with each other. If they could get along, if presidents Biden and President Xi figured out some way that we're going to put this national security stuff to the side and everything will be fine and we'll trust each other more, then it would be great if trade negotiators on the US side and on the Chinese side and with other trading partners as well in Europe, Japan, the other major economies of the world could get together and decide on where the trade conflicts really are in terms of the trading rules.

What is it really in the Chinese system that's very different as an economic system than ours or the system in Europe? Where is it that we really do have difficulties that we need to create some new rules? That's what I would like to see happen. I'm not predicting that it's going to happen because ultimately, I think it's out of the hands of the trade nerds like me out there in the world, and much more in the sphere of those handling national security.

Michael Klein:
Well, you and I both wish that the world was more like what trade nerds wished it would be like, but until that happens, it's still very valuable to get insights from trade nerds, or maybe put it differently, trade experts like you, Chad. Thank you very much for joining me once again on EconoFact Chats.

This has been EconoFact Chats. To learn more about EconoFact and to see the work on our site, you can log in to www.econofact.org. EconoFact is a publication of the Fletcher School at Tufts University. Thanks for listening.