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## 3 Understanding trade wars

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A popular view among economists is that recent US trade actions defy economic logic, because these actions seem to link gains from trade to bilateral trade imbalances and treat trade as a zero-sum game. According to this view, these actions are undesirable because they will lead to higher tariffs; that could happen either by design or, if the tariffs are a ploy to induce liberalisation abroad, because the ploy will fail and the higher ‘bargaining tariffs’ will remain. And it follows from this view that, in the event that the trade wars do lead to negotiated outcomes that result in more open markets, these tactics must be regarded as a success.

We describe here an interpretation of current US trade actions that is at once more charitable and less forgiving.<sup>2</sup> More charitable, because according to our interpretation it is possible to see a logic to these actions: the US is initiating a change from ‘rules-based’ to ‘power-based’ tariff bargaining and is selecting countries with which it runs bilateral trade deficits as suitable targets of its bargaining tariffs. Less forgiving, because the costs of these trade tactics cannot be avoided even if they happen to deliver lower tariffs. Rather the main costs will arise from the use of the tactics themselves, and from the damage done to the rules-based multilateral trading system.

<sup>1</sup> Thanks to Treb Allen, Emily Blanchard, Chad Bown, Davin Chor, Swati Dhingra, Caroline Freund, Penny Goldberg, Judy Goldstein, Henrik Horn, Doug Irwin, Petros C. Mavroidis, Emanuel Ormelas, Nina Pavcnik, Alan Sykes, Nick Tsivanidis and Ben Zissimos for many helpful comments. All remaining errors are our own. The views expressed in this chapter are those of the authors and should not be attributed to the institutions to which they belong. Research for this chapter has been supported in part by the World Bank’s Umbrella Facility for Trade.

<sup>2</sup> In Mattoo and Staiger (2019), we develop this interpretation more fully.

## **Trade wars and the rules-based multilateral trading system**

The most-favoured nation (MFN) principle and reciprocity are two pillars of the General Agreement on Tariffs and Trade (GATT)/WTO rules-based multilateral trading system. MFN embodies the nondiscrimination principle: imports of the same product from different countries have the right to face the same (MFN) treatment in a given market. Reciprocity refers to the notion that bargains should be balanced: due to the agreed tariff liberalisation, each country can anticipate an increase in the volume of its exports that is roughly equivalent in value to the increase in the volume of its imports.

These rules constrain the exercise of power in tariff bargaining (Jackson 1989). MFN dilutes the ability of a powerful country to capture the gains from pressuring bargaining partners to lower their tariffs, because any gains will be shared as well by third-country exporters. And reciprocity serves to further neutralise the exercise of power in tariff bargains, because it establishes an expectation of balanced terms for the bargain.<sup>3</sup>

Recent US trade actions can be seen as an attempt to escape from these constraints, an attempt that is made clear in the following statement by Wilbur Ross, US Secretary of Commerce:

An ideal global trading system would facilitate adoption of the lowest possible level of tariffs. In this ideal system, countries with the lowest tariffs would apply reciprocal tariffs to those with the highest and then automatically lower that reciprocal tariff as the other country lowers theirs. This leveling technique could be applied product by product or across the board on an aggregated basis. Such a modification would motivate high-tariff countries to reduce their tariffs on imports. (Ross 2017)

The system envisaged by Secretary Ross would abandon MFN and introduce an unprecedented notion of reciprocity – in tariff *levels* rather than in negotiated tariff *changes*. It would repeal the rules-based multilateral trading system and replace it with

<sup>3</sup> Bagwell and Staiger (1999) show that when applied together and strictly enforced, MFN and reciprocity can induce bargaining outcomes that are completely independent of the relative bargaining power of the negotiating parties.

something more like a power-based system where countries are no longer constrained by the old agreed-upon rules of behaviour.

### **The meaning of recent US trade actions: Bargaining tariffs**

We interpret recent US trade actions as reflecting a strategy of bargaining tariffs, whereby US tariffs are increased above the levels to which the US has committed in existing trade agreements with the goal of inducing US trading partners to reduce their tariffs. That raises the question of why bargaining tariffs are needed to achieve this goal, when they were not needed to bring bargaining partners to the table over the past 70 years of successful GATT/WTO liberalisation. We suggest two answers.

First, the threat of bargaining tariffs is needed to spur MFN negotiations between the US and other industrialised countries such as Japan and the EU (and preferential tariff bargaining with countries such as Canada, Mexico, and South Korea), because reciprocal tariff bargaining has largely run its course with these countries and most of the positive-sum gains from reciprocal tariff liberalisation have already been achieved by earlier trade agreements. Given this, any further tariff negotiation beyond the tariff commitments already made in those agreements amounts to a reallocation among countries of the existing spoils from globalisation – in effect, a zero-sum game. And the threat of bargaining tariffs *is* needed to induce a (zero-sum) reallocation of these spoils.

Second, large developing countries such as Brazil, China, and India were mostly inactive during earlier episodes of reciprocal liberalisation but have now grown to a size where their markets and protection matters. This has created a ‘latecomer’s problem’: positive-sum gains from reciprocal tariff liberalisation are likely available for these countries, but industrialised countries now have low levels of protection and little to offer these countries in reciprocal bargains. Here again, given existing US tariff commitments, the threat of bargaining tariffs is needed to induce these countries to reduce their tariffs.<sup>4</sup>

4 Bagwell and Staiger (2014) define the latecomer’s problem. They also describe a possible approach under which GATT Article XXVIII renegotiations could be used in the context of the Doha Round to achieve bargaining tariffs against latecomers while maintaining MFN and reciprocity. The difference is that the approach to the latecomer’s problem that they describe would stay within the rules-based system and hence not allow the exercise of US bargaining power. Beyond the latecomer’s problem, there are also unique trade policy issues raised by the nature of China’s economy.

But why choose as targets of its bargaining tariffs countries with which the US runs large bilateral trade deficits? A possible reason is that US bargaining tariffs can succeed in rebalancing the terms of existing trade agreements in favour of the US only if its bargaining partners cannot muster as strong a tariff threat of their own. Bilateral trade imbalances can serve as a possible metric for identifying ‘weaker’ countries where US bargaining tariffs could have the intended effect.

Hence, rather than interpreting recent US trade actions as reflecting the view that (i) trade is a zero-sum game, and that (ii) bilateral trade deficits signify trading partners with whom the US loses from trade, we can interpret these actions as arising from a view that (i) *negotiating further trade agreements* is a zero-sum game (or subject to the latecomer’s problem), and that (ii) bilateral trade deficits signify trading partners with whom *US bargaining tariffs create the strongest threat point*.

### **Hegemonic transition: The fall (and rise) of the rules-based multilateral system**

Above we have argued that the US is initiating a change from rules-based to power-based tariff bargaining. But why is this transition happening now? In 1947, the US was the unquestioned hegemon of the world economy and played a central role in the creation of the GATT (Irwin et al. 2011). Below we describe how it can be in the enlightened self-interest of a sufficiently dominant hegemon to provide support for a rules-based system that limits its ability to exercise power; but as the dominance of the hegemon wanes, this support can erode, precipitating the collapse of the rules-based system until another sufficiently dominant hegemon rises to take its place.

Imagine a hypothetical four-stage hegemonic transition between two countries, which for purposes of illustration we refer to as the US and China. This transition begins with a phase of US hegemony, after which relatively faster growth in China causes the relative power positions of the two countries to evolve through a phase of US dominance, then Chinese dominance, and finally to Chinese hegemony.

To understand the equilibrium regime under US hegemony (and, by symmetry, in Chinese hegemony), recall from earlier that a commitment to MFN and reciprocity dilutes the exercise of power. Of course, this commitment benefits the weak, but

paradoxically it can also be valuable for powerful countries when they are at their most powerful. This is because as hegemon, such countries need to find some way to commit not to exploit the weak ex post, once the bargaining has begun and the latter are trapped by relationship-specific sunk costs or become vulnerable to exclusion from trade deals between the hegemon and other weak countries. Absent such a commitment, the weak might simply stay away from the bargaining table, depriving the strong of any gains from trade bargaining. By restraining the strong, the rules-based system encourages participation of a broader set of countries in the global economy, benefiting the weak and the most powerful countries alike (Bagwell and Staiger 1999, Bagwell et al. 2018, Goldstein and Gowa 2002, McLaren 1997).

Therefore, in the US hegemony phase, the US chooses to tie its hands in a rules-based regime in order to ensure the participation of the weak (China before its rapid growth phase). During the US dominance phase, China would like to continue to threaten not to bargain with the US in the absence of rules, but unlike in the US hegemony phase this threat is not credible, and hence the US does not need to rely on rules to induce China's participation. For this reason, in the US dominance phase the US does better in a power-based regime than a rules-based regime and chooses to escape from its constraints. The remaining phases are then mirror images of the first two phases just described. In the Chinese dominance phase, China now does better in a power-based regime than a rules-based regime and chooses not to support a rules-based regime. And finally, in the Chinese hegemony phase, China chooses to tie its hands in a rules-based regime.

The duration of the phases will depend on the policy choices of the countries to the extent that those policy choices determine their relative growth rates. Suggestive of the pro-active industrial policies adopted under the China 2025 programme, China clearly has an incentive to accelerate the transition from US dominance to Chinese dominance. By the same logic, the US has an incentive to prevent, or at least delay, the transition, suggesting an added rationale for the trade and investment restrictions it is imposing on China.

## **The cost of trade wars: Losing the benefits of the rules-based system**

The rationale provided in the previous two sections for recent US trade actions relies on a myopic logic, even from a purely US perspective. Apart from MFN and reciprocity, reputation and norms of cooperation also matter in the rules-based system. The recent US trade actions have adversely affected these features and may cause irreversible damage to the system in a way that would also hurt longer-term US interests.

Above, we focused on the possibility that a country would deviate from a prior agreement and use bargaining tariffs against a ‘weaker’ trading partner with which it runs a bilateral trade deficit. But it may then become acceptable for its other bargaining partners to resort to the same strategy. And if this happens, any initial bargaining advantage the country enjoys from being the first to exploit this strategy would quickly disappear. In fact, it may be hard to maintain any cooperation at all because of the multilateral enforcement issues that arise in this setting (Maggi 1999).

The hegemonic transition described in the previous section assumed that China’s optimal actions when it becomes the hegemon were completely independent of US actions today. But by breaking rules today, the US could damage the reputation of the multilateral trading system and hence deprive a future hegemon of a commitment mechanism. The resulting period of Chinese hegemony without the benefit of an effective rules-based system could be costly for the US.

Undermining the central WTO rules could be costly in other ways. MFN and reciprocity can mitigate both the strategic behaviour and the bargaining frictions that can accompany such behaviour (Curzon 1966, Schwartz and Sykes 1997, Bagwell and Staiger 2005, 2010, 2016, 2018, Bagwell et al. 2018, 2019). By contrast, there is ample historical evidence that the use of bargaining tariffs leads to outcomes far away from those that might be considered desirable or efficient. The disappointing European experience with bargaining tariffs during the second half of the 19<sup>th</sup> century has been documented by Wallace (1933: 630).

## **Conclusion: The enlightened self-interest of a declining hegemon**

The US may be resorting to bargaining tariffs to extract more of the gains from cooperation with other relatively open industrial countries, and to induce greater liberalisation in relatively protected large developing countries. In parallel, the declining relative importance of the US in the world economy may have diminished the need to reassure trading partners by committing to a rules-based system, and increased the incentive to delay hegemonic transition.

However, a less myopic view would dictate greater US restraint. If other countries follow the example of the US, then the US will likely lose any benefits from its actions, and multilateral trade cooperation will collapse. If US actions durably damage the rules-based system, the US may ultimately be hurt by the absence of restraints on the actions of a future hegemon.

The US may also be better off with rules-based trade bargaining in the period of Chinese hegemony than with power-based trade bargaining in the period of Chinese dominance. This has a surprising implication: if the transition from US to Chinese dominance cannot be avoided, then the US might be better off facilitating China's rise, through the phase of Chinese dominance and to the phase of Chinese hegemony. This course of action could reflect the enlightened self-interest of the US while at the same time averting the conflicts that have tended to arise between incumbent and rising powers.

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