

March 31, 2018

Economic Commentary

The Demise of Free Trade/Fair Trade

Upon reflection it seems to me that the root cause of today's tumultuous international trade environment can be traced back to 1994. Because the North American Free Trade Agreement (NAFTA) renegotiation has been so widely reported on, almost everyone knows that the agreement was signed in 1994 by President William Clinton and ratified by the U.S. Senate that same year. Much less well known is that 1994 was also the year that the General Agreement on Tariffs and Trade (GATT) collapsed, as the participating countries failed to conclude any new trade agreements. Led by the United States, GATT had been in place for over 40 years and worked to reduce trade friction among almost all of the industrialized nations.

Rather than deal with the trade barriers that were proliferating at that time as a means of gaming the rules under GATT, trade diplomats from individual countries decided to paper over the problems by creating the World Trade Organization (WTO) with slightly better mechanisms to settle their disputes. With this new structure in place the general thinking was to be as inclusive as possible and to bring all the world's economies into membership. This led the United States, under President Clinton, to propose the admission of China to the WTO in 2000. Again, the general thinking was that China's membership would provide a means to encourage liberalization within China's economy and move them towards more representative and democratic governance over time.

During the first calendar quarter of 2018, the Chinese government convened its regular five year meeting of the leadership of the Communist Party. The meeting confirmed that President Xi Jinping would now serve as "President for Life." This vote conclusively disabused anyone of the notion that China would become more "westernized" through its WTO membership. As a consequence of this vote, I believe the days of the WTO are numbered and that its usefulness is steadily declining. Although press coverage of the United States withdrawing from the Trans Pacific Partnership (TPP) was described as a disaster, I believe President Donald Trump was correct in his assessment that it had benefitted the twelve Asian signatories at the expense of the United States. Any fair evaluation of the TPP would show that the economic benefits that accrued to American exporters was far outweighed by the economic benefits accrued by the Asian states.

A review of some of the aspects of current trade agreements illustrates the maddening inconsistency of the logic that underlays their terms. NAFTA is a good place to start. Ever since NAFTA was ratified it has been obvious that Mexico's economic comparative advantage is its low labor costs relative to the United States and Canada. Consequently, the production of low profit margin products like compact cars, has largely moved from the United States to Mexico. Those cars are exported to the United States duty free, making it virtually impossible for any car manufacturer in the United States to compete with Mexican car production. Many American jobs have been outsourced to Mexico and the United States is precluded by NAFTA terms from placing a tariff on Mexican based imports to the United States. Consequently, there is currently no way to equalize the cost disadvantage to U.S. companies.

In regard to trade agreements with Europe, the United States assesses a 2.5% tariff on automobiles entering the United States while the European Union levies a 10% tariff on U.S. automobile exports to Europe. The European position is that figuratively, a BMW sedan produced in South Carolina and shipped to Europe undercuts BMW production in Bavaria because German wage rates are higher than those in the United States. Therefore the tariff disparity is justified, according to Europe, and this view is affirmed by the WTO. The United States position that the tariff on imported cars should be the same for both Europe and the United States is eminently reasonable, but unenforceable in a trade dispute through the WTO.

In late 2017 the Trump Administration announced tariffs on lumber imported from Canada, principally British Columbia and Alberta. The reason for the tariffs was the practice by Canadian provinces of allowing timber harvesting on provincially owned lands at virtually no cost. United States forest product companies could not qualify for this benevolent treatment in Canada, only Canadian producers. The Canadian government vowed retaliation against these tariffs and filed a case with the WTO. WTO case legal pundits claim Canada's case is strong because the actions were taken by Canadian Provinces, not the Canadian Federal government.

Present day examples of problematic trade practices abound. China produces 49% of the world's annual steel production. The U.S. imports only 2% of its steel directly from China. Canada exports steel representing 16% of U.S. steel consumption. However, if one adds Canada's steel exports to the U.S. with its own domestic consumption, the total exceeds Canada's domestic production of steel. Either Canada is reducing its inventory of steel produced in prior years or it is importing more steel. In mid-March Canadian Prime Minister Justin Trudeau announced that Canada was committed to working with the U.S. to reduce the amount of foreign steel that was transshipped through Canada to the United States. The origin of that steel is China and its circuitous route from there through third party countries is an attempt to game the system definitions of the Rules of Origin contained in NAFTA.

South Korea is the largest importer of Chinese steel in the world. South Korea accounts for 7% of steel imports into the United States. Korea's largest volume of exports to the United States in dollar value is vehicles manufactured by Hyundai and Kia. Korea is also the world's second largest producer of ocean going ships. All the steel utilized in the manufacture of ships and automobiles meant for export from Korea exceeds the amount of Korea's domestically produced raw steel. Consequently, it is obvious that some portion of the steel fabricated in Korea comes from raw and semi-finished steel imported from China. This is part of the state subsidized Chinese steel industry "dumping" steel at below market prices with Korea as the willing buyer.

Late in March the United States announced that Korea would be exempt from the 25% tariff on steel imported into the United States. At the same time Korea announced that it had agreed to reduce steel exports to the United States by 25%, a quota Korea accepted in exchange for being exempted from the general 25% steel tariff proposed by the United States. While economists decried the use of a quota as an impediment to free trade, it is obvious the two countries agreed on a solution that satisfied both sides in the negotiation.

Opponents of the Trump Administration's approach to international trade concede that there have been multiple examples of unfair trade practices, particularly in the area of theft of intellectual property involving technology patents and processes. Everyone understands that the foremost practitioner of this theft of American innovation has been China. However, the

most often cited method for stopping these violations is to file claims with the World Trade Organization.

The United States has been the largest initiator of unfair trading practice cases at the World Trade Organization (WTO). Cases take years to be decided and years more after appeals are filed from the offending party, most often China. With the pace of technological change accelerating, the World Trade Organization no longer meets its initial purpose, which is the promotion of free and fair trade among nations. The World Trade Organization was founded in 1995 because the prior arbiter of international trade, the General Agreement on Tariffs and Trade (GATT) broke down when no more trade agreements could be generally concluded. The WTO has now reached the same impasse and the Trump Administration is proactively seeking remedies outside the framework of the WTO.

Secretary of Commerce Wilbur Ross has been vilified by the *Wall Street Journal* and others for his efforts to correct trade inequities one product and one country at a time. I applaud his efforts to bring a rational, symmetric trade regimen into being with all our trading partners, one bi-lateral agreement at a time.

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President