WILL AND SHOULD THE U.S. (AND EUROPE) DECLARE (TRADE) WAR ON CHINA? THE POLITICAL ECONOMY OF TRADE CONFLICT.

Carlos A. P. Machado, Escola de Economia e Gestão, Universidade do Minho, 4710-057 Braga, Portugal

(Phone 003512534567, Fax 00351253676375, E-mail pascoa@eeg.uminho.pt)

Abstract

Globalization is taking hold of our imagination and of our scientific and political curiosity. Off-shore outsourcing, Safeguard clauses against the import of Chinese textiles, anti-dumping measures against all other kinds of imports from the same origin, backlash against Chinese foreign direct investment (FDI) are the order of the day and, for some, shaking up trade theory. Should we worry about this from the substantive point of view? Or should we confine our worries to the media, political and public opinion undercurrents emerging lately?

Introduction

We will try in this paper to answer following questions:

1. Is there a “yellow danger” in terms of trade, investment and/or other fields?

2. Is orthodox trade theory, and/or free trade passé?

3. If you answer yes to any of the previous questions, then, what could and should be done about it? Go to war? Make peace? Or opt for a third way?

4. What are the odds of a trade war with China in the near future?

Safeguard clauses, anti-dumping suites and other measures against imports from China

By 2004, around 15% of anti-dumping actions world wide occurred against China. Since China joined the WTO in 2001 China had been subject to more than 200 anti-dumping cases. (Mallon & Whalley 2004, p.13) It’s mainly in this context that China seeks to qualify as a market economy. “Under US anti-dumping laws, once a US trade authority deems a country a non-market economy it may disregard the prices of products exported from the country, since they do not reflect supply and demand, and instead use costs in a third surrogate country to calculate dumping margins.” (Mallon & Whalley 2004, p.13)

As of mid-August 2005, the U.S. was still negotiating an agreement on textiles and shoes, and some differences prevailed at that date. Chinese exporters and U.S. importers and retailers of textile products were lobbying for liberal clauses (i.e. higher or no quotas) and U.S. textile producers were pressing the government and lawmakers in the opposite direction.
Earlier in the year 2005 China had struck a deal with the European Union that restricts growth of clothing shipments to between 8 and 12.5 percent through 2007. This could be seen as a benchmark for the U.S. – China deal that was struck at the end of 2005, restricting through quotas the growth of Chinese exports of textiles and clothing to the U.S. until the end of 2008.

Mid-2006 horse-trading was reportedly going on among European governments over anti-dumping tariffs on cheap Asian shoe imports namely from China and Vietnam. Producer and importing countries were pulling in opposite directions and would eventually cancel each other out. (Financial Times, September 25, 2006)

More recently – February 2, 2007 - the US “launched a trade dispute with China over alleged subsidies for manufacturing exports in an escalation of tensions with Beijing” (Callan & McGregor, 2007) Tax rebates and other types of subsidies offered across the spectrum of industry sectors in China were the target of this case brought by the US administration before the World Trade Organisation (WTO). This trade complaint was suspected to be motivated by the need to win congressional approval for the renewal of the US president’s fast-track trade negotiating authority, about to expire on June 30.

**FDI from China more dangerous than Japanese FDI?**

One difference between Chinese and Japanese FDI could be traced to the fact that Japan stayed after World War II always a loyal ally of the US. The same could not be said of China…
The reported events below could very well have triggered a rising protectionist attitude with the Chinese authorities in relation to foreign firms willing to invest there. In face of the fact that two thirds of Chinese exports were generated by companies with foreign investors, up to 80% in high-value-added sectors like IT, and that foreign involvement was far less in the economies of Korea and Japan at similar stages of development, foreign access to the Chinese market was becoming an “incendiary issue”. (Time, September 25, 2006)

**Lenovo/IBM laptops**

This acquisition was apparently working out well, at least those are the results known from the first quarterly reports after the takeover operation. More recently, however, “Lenovo’s PC shipments have grown more slowly than the industry average for four of the past five quarters.” (Schuman 2006) Apparently, the challenge is that Lenovo doesn’t have a brand name in the U.S., but according to this source, “Lenovo is being buffeted by the sometimes tense relations between the West and China. In May, the U.S. State Department said 16,000 PCs it had purchased from Lenovo wouldn’t be used for classified work after a Congressman claimed that the Chinese-made computers would threaten national security.” This, in spite of Lenovo’s new headquarters being located in Raleigh, North Carolina. Most manufacturing operations were in China, though.

This poor state of affairs tended to drag on in 2007, mainly in the USA (Spencer).

**Haier’s bid for Maytag**

“Haier, China’s largest appliance maker, has withdrawn from a $1bn-plus bid battle for its US rival Maytag because of concerns over price, the complexities of integrating the two businesses, and fears of a US political backlash, …” (Financial Times July 21, 2005)

**CNOOC’s bid for UNOCOL**

Paul Krugman (2005) believes that the Chinese challenge “looks a lot more serious than the Japanese challenge ever did.” But, why? “Yet there are two reasons that Chinese investment in America seems different from Japanese investment 15 years ago. One difference is that, judging from early indications, the Chinese won't squander their money as badly as the Japanese did…. The more important difference from Japan's investment is that China, unlike Japan, really does seem to be emerging as America's strategic rival and a competitor for scarce resources - which makes last week's other big Chinese offer more than just a business proposition.” (Krugman is referring to the bid by China National Offshore Oil Corporation (CNOOC) for Unocal, a U.S. energy company, adding as a side quip: “Buying a company is a lot cheaper, in lives and money, than invading an oil-producing country.”) Krugman goes on, without loosing any time with a justification: “If it were up to me, I’d block the Chinese bid for Unocal.”

He got company: Amity Shlaes (2005) agrees with the complaint “that China is driving up the oil price and 'taking US energy. Both are true – but growth anywhere does that.” She speculates: “If Lenovo, Haier or CNOOC were private companies, their acquisitions would trouble Americans less. But US citizens are not comfortable with the idea of the Chinese public sector buying up the US private sector.” She finally concedes: “There is something anachronistic and disturbing about
an economy of China’s size operating under an authoritarian government.” I wonder what size has to do with it? She would rather have that “a nation of traders and private companies is inherently less of a security threat than a corporatist giant.” So, that would be the final reason for Americans, like Shlaes, to oppose Chinese FDI in the US and to favor protectionist attitudes. “It will be because they decide that the old China bet is off.”

Joe Bolton, the Texas Republican who chaired the House Energy and Commerce committee, warned… “this transaction poses a clear threat to the energy and national security of the United States.” (Financial Times, June 29, 2005)

Others would rather share the opinion of Guy de Jonquières (2005) according to whom “[t]he paroxysms of anxiety unleashed by the bid by China National Offshore Oil Corporation for Unocal seem oblivious to reason or facts.”

In the meantime, the bid for Unocal was called off by CNOOC and Chevron, the US national hero, was probably taking advantage of that.

The recently noticed change of heart of the Chinese government and Chinese economic agents towards foreign investment can be seen as, among other causes, a result from this.

**The renminbi (also known as yuan) (under)valuation**

“China has bowed to intense foreign pressure and growing domestic economic imbalances by replacing its decade-old currency peg to the US dollar with a more flexible exchange rate system that will be tightly managed by the central bank.

The People’s Bank of China, the central bank, announced a 2.1 per cent revaluation yesterday and the details of a system that will allow the renminbi to fluctuate by 0.3 per cent in daily trading.” (Financial Times, July 22, 2005)

This can be interpreted as still another sign that the Chinese government is willing to play by the rules of the international system and does not wish to antagonize its biggest counterparts in world affairs.

However, a bill was recently introduced by senators Charles Schumer and Lindsey Graham, proposing a 27.5 per cent tariffs on Chinese imports “in retaliation for Beijing’s alleged undervaluation of the renminbi”, reflecting growing frustration with China’s obduracy in making only small incremental changes to its exchange rate regime.” (Financial Times, September 28, 2006)

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1 Hufbauer and co-authors (2006) counted more than 15 new bills introduced in the US Congress against Chinese practices since January 2005
Some estimated (Hufbauer et al, 2006, p.10 and 27) that resolving this dispute “along the lines advocated by US officials [a 20 percent Chinese currency appreciation over two years] might reduce the bilateral trade deficit by $60 billion to $80 billion [to $120 billion according to others, out of a $185 billion bilateral trade deficit] – a figure that, even if somehow exaggerated, dwarfs all other trade disputes combined.” Assuming of course that the revaluation is accompanied by an improved balance between saving and investment in the United States.

In this respect however, one should eventually notice that “the hypothesis that a deterioration of the trade balance is correlated with a contraction of manufacturing output” has recently been rejected at the 5 percent significance level by Hufbauer, Wong and Sheth (2006, p.3) estimates, based on 1990 to 2005 quarterly data. According to these authors, instead of a US manufacturing trade deficit causing a decline in US manufacturing output, it was changes in national income that drove both US imports of manufactures and US output of manufactures, explaining the apparent paradox according to which “a larger US manufacturing trade deficit generally corresponds with higher, not lower, US manufacturing output.” They summarize: “the political arithmetic that equates trade deficits with job losses is either exaggerated or plain wrong.” (ibidem)

Voon, Guangzhong & Ran (2006) believe to have shown that “China’s export sector may not necessarily lose from the Central Government’s decision to revalue its RMB [Renminbi] against the US dollar…”

**Frequency and importance of trade disputes**

The number and reach of trade disputes filed with the WTO could also be interpreted as a symptom of trade conflict between the nations under scrutiny. However, this proves to be a non-starter, at least at first sight, as the most conflict prone economies seem to be by far the USA and the EU.

Perhaps this measure could/should be refined by the weight of the dollar amounts involved in each dispute…

**Number of trade disputes filed with the WTO**

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Is orthodox trade theory, and/or free trade passé? Is Globalization Shaking Up Trade Theory? Really?

“The theory of comparative advantage is one of the few bits of stational logic that economists of all schools understand and agree with.” (Samuelson 1976, p. 96)

Alerted by a Business Week article (Bernstein 2004) to the fact that trade theory was under attack by several U.S. economists, among whom Paul Samuelson, I looked up his JEP article (Samuelson 2004), that somehow had passed unnoticed by me, where I was supposed to be able to read that “comparative advantage cannot be counted on to create…net gains greater than the net losses from trade.” (Samuelson 2004 as quoted by Bernstein 2004)

“Net gains greater than net losses” did not sound very Samuelsonlike prose, and indeed I was not able to trace that sentence in his text. The next best thing I could find in Samuelson’s worst case scenario (Act II) read more like this: “[T]he new Ricardian productivities imply that, this invention abroad that gives to China some of the comparative advantage that had belonged to the United States can induce for the United States permanent lost per capita income – an Act II loss even equal to all of Act I (a)’s 100 percent gain over autarky.” (Samuelson 2004, p. 137)

That could be interpreted like this: Through technical progress in China/India, materialized as inventions and offshore outsourcing, in the goods/sectors where previously the US registered a comparative advantage, relative productivity rates could evolve of sorts into a pattern where no comparative advantages could be identified any more. Productivity rates would become so aligned that in the absence of prevalent comparative advantage both the U.S. and the rest of the world (China/India) would evolve to a situation of autarky, where obviously all the previous gains from trade would be lost. That would mean that (per capita) income after technical progress in the import substituting industries of China/India would be less in autarky than with trade for the U.S., where technical progress had ceased to exist.

Even though this assumption looks more prone to scare naïve John or Jane Doe, U.S. economists or not, we gladly concede that comparative advantage patterns can change over time, that gains from trade can decrease, according with these developments, but a return to autarky conditions could arrive only by chance under very specific conditions.
I cannot avoid noticing how often and easily some highly regarded U.S. authors crack under pressure of events and pander to the fears of the common man, perhaps under the influence of mass media that are not able to confront the ideas of the hour. It was like that with the Soviet threat and the Sputnik phenomenon after World War II, then Japan bashing became de rigeur in the eighties, later with the Asian tigers of the nineties, and more recently with the China/India syndrome around the offshore outsourcing and cheap manufacturing developments. In this context Paul Krugman’s interpretation of the Asia miracle (Krugman 1994) seems to convey the right attitude towards these one off developments of “input-driven growth”, that are an “inherently limited process”. All above mentioned threats are largely “one-time changes in behavior that cannot be repeated”. Most of those countries are “unlikely to achieve future growth rates comparable to those of the past”, because their growth can mostly be explained “by increases in measured inputs” and not so much by increased efficiency in their use.

I dare to submit that we are presently dealing with this type of input-driven growth. It’s déjà vu all over again! Any traces of anxiety are misplaced and we do not need nerves of steel to stay confident that the U.S., and I dare say, Western total factor productivity growth rates will prove solid enough to keep these economies in the frontline of progress providing a well deserved well-being for their citizens. Salaries of high and low skilled labor will rise in the East, as it will become increasingly scarce. Unions and other democracy of sorts institutions will contribute towards that welcome development. The Chinese currency will become unstuck from the US dollar. Paraphrasing Paul Krugman (1994, p. 76), regarding what he described as the China syndrome: “There will still be substantial shift of the world’s economic center of gravity, but it will be far less drastic than many people now imagine.” He found no reason to believe that, even if “imports from those nations undermine the West’s industrial base” and the observed “diffusion of technology will place huge strains on Western society”, overall world technological gaps are vanishing. (Krugman 1994, p. 77) He refused then to give in to the views that “assert that East Asian economic success demonstrates the fallacy of our traditional laissez-faire approach to economic policy and that the growth of these economies shows the effectiveness of sophisticated industrial policies and selective protectionism.” (Krugman 1994, p. 78) So we should now not give in to the sirens of despair and fear. We should instead welcome the arrival of these billions of human beings to the welfare modern capitalism can provide.

Free trade is not yet passé (Krugman 1987), and the “case for an active or responsive U.S. trade policy, although conceivable in theory under some circumstances, is weak in theory and practice.” (Dixit 1989, p. 247)

The problem Bhagwati and co-authors (2004) deal with is somewhat more restricted to trade in services, namely in those amenable to be supplied from a distance, “with the supplier and buyer remaining in their respective locations”, probably with the help of broadband internet connection. Besides reminding us that such trade in services “cannot be readily subjected to customs inspection”, they come to a similar conclusion to Samuelson’s: first, that “the aggregate effect of

\(^{2}\) That they inaccurately brand “offshore outsourcing” (Bhagwati et al. 2004, p.105).
outsourcing has so far been negligible” (Bhagwati et al. 2004, p. 98) on the U.S. economy (and the less so for the other developed countries); second, that “even if outsourcing sometimes reduces jobs proximately at certain firms or in certain sectors, in other cases it can help to create new U.S. jobs” (Bhagwati et al. 2004, p.99); third, that the net trade balance in this type of services “is almost certainly in America’s favor”, since the U.S. economy offers high-value while importing low-value ones instead; fourth, “the overall message of the models is that offshore outsourcing is generally beneficial to an economy” with the conventional theoretical caveats of distributional and terms of trade effects. (Bhagwati et al. 2004, p.101) They presented three models of trade in services, according to which “free trade with outsourcing will be preferable to free trade without outsourcing in an economy with fixed terms of trade and no other distortions”. (Bhagwati et al. 2004, p.104) “In the first model, outsourcing benefits society, but the benefits arrive in a combination of higher returns to capital and lower wages. In the second model, with multiple factors of production and fixed goods prices, outsourcing again provides aggregate benefits, but some workers gain while others lose. In the final model, outsourcing provides benefits in a way that, at least after workers make a transition to other industries, leads to higher real incomes for all workers.” (Bhagwati et al. 2004, p.105)

According to these authors, there is only one chance that this results in net losses for the U.S. economy. “If terms of trade deteriorate for the United States, this secondary loss can outweigh the primary gain from the lower wage of skilled offshore services, resulting in a net loss of U.S. welfare.” (Bhagwati et al. 2004, p.106) This is the old model of immiserizing growth, standard now in the international economics textbooks, that applies only when the country has market power in the international transactions of the good or service in question.

Johnson & Stafford (1993) had already contemplated the possibility now envisioned by Samuelson (2004) again. “The effect of foreign competition in reducing the relative price of the goods that the United States formerly exported can lower aggregate real income in the United States even as world income rises.” (Johnson & Stafford 1993) This doesn’t coincide with the “immiserizing growth” case, as the terms of trade deterioration affects “formerly exported” goods, and not the expanded export sector anymore. They seem however to equate aggregate real income with “average living standard”, and “real wage”, when they expect the fall of both these latest indicators “relative to trend”.

According to them, “[m]ore than 100 percent of the benefits of an increase in world GNP due to an increase in the productivity of the B industry in one of the countries goes to the source country.” Hence, the role for restrictive trade practices they allow, under certain conditions and up to a certain point, in order to increase real wages to levels higher than under free trade. “[R]eal wage growth can fall below productivity growth as international competition changes the terms of trade. It is possible to have a productivity slowdown and a wage decline.” (Johnson & Stafford 1993)

Gomory & Baumol (2000) dwell in the same belief that especially in a world with scale economies and retainable industries many outcomes are possible and in some of them “improvement in one country’s productive capabilities is attainable only at the expense of another country’s general welfare.” (ibidem, p.4) The term ‘retainable industry’ is used by these authors “to refer to any industry that is characterized by such start-up costs and the resulting difficulties for small-
scale entry” (*ibidem*, p.17), i.e. to industries with high entry barriers, and where each good tends to be produced in only a single economy. Such outcomes are labeled “perfectly specialized equilibria”.

These outcomes seem however to be in contradiction with the rise of intra-industry trade.

In a world such as the one depicted by Gomory & Baumol (2000, p.56) “an industrialized country will benefit if an underdeveloped trading partner acquires new industries and generally improves its productivity. It will continue to benefit until that partner reaches a level of development that enables it to play a more substantial role in the global marketplace. After this point acquisition of more industries by the newly developing partner becomes harmful to the more industrialized country.” Substitute USA and China for industrialized country and underdeveloped trading partner and you got the Samuelson’s case of USA versus China.

The threshold level between zone of mutual gain and zone of conflict would lie in terms of relative wages practiced in the less developed country around one-third of the prevailing wage level in the developed partner. (Gomory & Baumol 2000, p.100) At first sight the working conditions in China would still be far from this threshold.

**The world according to Paul Samuelson et al in a piece with two acts**

Samuelson (2004) depicts a world potentially developing in two different directions: the right one described in Act 1, with a part a) and b), and one where everything goes terribly wrong, in Act 2.

Let’s see the story in a few frames, like out of a comic book:

In Act 1 all is rosy, even before progress sets in. China and the USA have different population sizes, but this is compensated by productivity differences in favor of the U.S. worker, and overcompensated in the U.S. exporting sector, where the productivity superiority is huge in comparison with the one in the other sector. Both countries gain from trading according to their comparative advantages (Act 1, part a).

Things get even better for both parties, if China achieves productivity improvements in its exporting sector, the one where previously was identified its comparative advantage. Never mind the considerable deterioration of China’s terms of trade. Things keep improving, when you go from Act 1, part a) to part b).

Things get out of hand in Act 2. The technical and other innovations still happen in China, but not in the exporting sector. It all happens in the previously import competing industries. This rebalancing act is pushed so far as to align both countries’ production possibilities and we come to a situation, where comparative advantages cease to exist. The countries are thrown back to a situation where no trade is economically justified from the comparative advantage point of view. Isolation gets the USA back to the situation where this whole story started to unfold. No wonder that this situation is worse for the USA than both interim situations with trade, in Act 1(a), and even more so in comparison with Act 1 (b).
Gomory & Baumol (2000, p.112) identified similar situations to the one described by Samuelson, when they describe an outcome where country 1 (USA) “will be driven from a result that is better for itself than autarky to one that is no better than autarky, and it will have been the increase in country 2’s [China] productivity that is responsible for country 1’s loss in welfare. To summarize, for a country to constitute an ideal trading partner, it must exhibit three characteristics. It must be the producer of a modest share of the traded commodities, leaving it with low relative wages and a small share of world income; it must be a maximally efficient producer of just those goods that it does supply; and it must be an inefficient producer of all the remaining commodities, so that it constitutes no competitive threat in those industries.”

Go to war? Make peace? Or opt for a third way?

The problem with trade wars resides mainly, as in any type of war, in the fact that you know quite precisely when it starts, but you don’t know when and where you are going to be capable of stopping it, and what kind of damages and benefits will derive from it.

Let’s start with examples of useful definitions of trade war.

“Trade wars are a category of intense international conflict where states interact, bargain, and retaliate primarily over economic objectives directly related to the traded goods or service sectors of their economies, and where the means used are restrictions on the free flow of goods or services…viz., economic means used for economic ends”. (Conybear 1987, p.3)

“Trade conflict is conceived of here as a continuum, ranging from zero conflict up to very high levels of conflict. It is the higher levels of conflict that may be said to constitute trade war…The continuum is measured by a combination of intensity and duration of conflict. … Thus, trade conflicts gradually become trade wars as the intensity of the conflict increases, and as the degree of interactive retaliation escalates.” (Conybear 1987, p.5-6)

Following Conybear, Zeng (2004, p.13 and p.79) defines trade war as “a sustained, high-intensity trade conflict involving at least one round of mutual retaliation.”

This process should preferably be analyzed both as a conflict between governments in the international, and as the result of an interaction between interest groups and politicians in the respective domestic arena. (Grossman & Helpman 1995, p.676) Since 1994 we knew that protection is for sale (Grossman & Helpman in idem 2002) namely in exchange for campaign and other contributions, and intuitively we knew it a long time before that. The politicians announce their electoral platforms and the lobbyists decide on how much to invest in their election, or the lobbyists set out to shape the politicians’ platforms beforehand. Concomitantly the politicians engage in conversations with other fellow politicians across the border. These conversations can reach a peaceful conclusion or else they can evolve into a series of unilateral measures that can escalate into a full-fledged all-out trade war.

Zeng (2004) apparently also embraces this two-level game approach. He detects two puzzles regarding the diverse commercial rivalries observed: “First, even though the United States has always been the country with greater aggregate power and bargaining resources in bilateral trade disputes, it has had uneven success in extracting concessions from its trading partners through
the use of coercive strategies.” (Zeng 2004, p.2-3) Japan and the European Union (E.U.) would concede to U.S. pressure a lot easier than for instance China, in spite of being a lot less dependent of the U.S. market than the US on theirs in comparison with this later country. “The second puzzle…is that the pattern of democratic peace that has been found to be a distinctive characteristic of international security conflicts does not seem to apply to trade conflicts. The empirical evidence…on the pattern of state involvement in the aggressive escalation of trade disputes leading to mutual retaliation suggests that trade conflicts between pairs that match democratic and authoritarian states have not more frequently escalated into trade wars than have conflicts between democratic trading partners. Indeed, statistical analyses of the determinants of trade retaliation indicate that states’ regime type has no significant bearing, in either a positive or a negative direction, on the probability of aggressive escalation of trade disputes.” (Zeng 2004, p.3)

Zeng (2004, p.5) “argues that a system-level variable, the structure of trade among nations (specifically, whether the bilateral trade relationship is complementary or competitive), affects threat effectiveness by influencing both the level of unity among domestic interest groups and the degree of divided government. The same factor also affects the propensity of trade conflicts to escalate into trade wars.”

It all would depend on the degree of complementarity versus competitive (substitutive) structure of trade between the two nations involved. As explained by Zeng (2004, p.5), “[t]he structure of trade…refers to the degree of to which two countries engage in the export of a similar set of commodities and can easily replace imported commodities with similar products produced at home, then they have a primarily competitive trade structure. But if each of them specializes in a different set of products in which it has a comparative advantage, and trades them for commodities that it is incapable of producing at a reasonable cost, then they have a complementary trade relationship. To put it in another way, trade complementarity involves the mutually beneficial exchange of goods in areas where each is deficient. By looking into the structure of trade among nations and its impact on domestic politics and international negotiating outcomes, this work offers a plausible explanation for the two empirical puzzles previously summarized, and, in doing so, it aims to capture an important aspect of the dynamics of international trade negotiations.”

“The United States will find it more difficult to extract concessions from countries with which it has complementary trade relations than from those with which it has competitive ones due to the greater degree of domestic division in the former. This is because when trade is competitive, sanction threats will likely enjoy support from both export-seeking and import-competing interests in the nation issuing the threat as both groups gain from aggressive tactics that promise benefits whether the threat succeeds or fails. … In contrast, when trade relations are complementary, domestic interests in the country issuing the threat will be divided in their policy preferences because of the division between export-seeking and import-using industries. Sanction threats in this case will enjoy backing only from export-seeking sectors, who only gain if the sanction threat succeeds. They will not enjoy support from the import-competing sector since such a sector will not exist in cases involving complementary trade relations. Instead, threats will encounter opposition from a large domestic constituency that makes use of imports from the target country.” (Zeng 2004, p. 16)
This would apply to trade relations between the United States and China, “two countries with a highly complementary trade relationship. In U.S.-China trade disputes, active opposition from a large import-using constituency that has developed a considerable dependence on the labor-intensive products made in China (such as apparel, textiles, and toys), coupled with a virtually nonexistent import-competing sector in the United States, has rendered America’s threat retaliation far less credible and effective vis-à-vis the Chinese. American threat credibility is further undermined by the greater degree of divided government in such cases. Since trade conflicts between countries with complementary trade relations will most likely involve noncompetitive, declining industries, the U.S. executive will be less inclined to respond to domestic protectionist pressure and to go along with the tougher approach advocated by the more hawkish legislature. Divisions in domestic interests and the wider gap between executive and legislative preferences should make U.S. threats of sanctions far less credible to the target.” (Zeng 2004, p.16-17)

It was further argued by Zeng (2004, p.17) “that the same set of factors that account for the variable degree of threat credibility can also help us understand the lack of democratic peace in trade. This is because countries with highly competitive trade relations ought to face stronger pressure for brinkmanship in bilateral trade disputes due to the greater degree of unity among domestic interest groups. At the same time, the executive in the sender of threat should be more likely to approve of the need to impose sanctions in these cases if he or she perceives that domestic pressure for compensation is strong enough or that an industry vital to the future economic well-being of the nation is genuinely threatened by foreign competition. These factors tend to push countries with competitive trade ties toward more aggressive tactics with a heightened risk of escalation to trade war. Since the majority of democracies also happen to be advanced industrial countries with highly competitive trade, this explains why democracies are not necessarily less conflict prone in their trade relations. In other words, trade structure, rather than regime type, provides the more proximate explanation for the trade wars we observed between democracies.”

Specifically regarding US-China trade relations Zeng (2004, p.7) remarks: “On the whole, it seems fair to say that U.S. coercive strategy has produced rather limited results in China: Beijing did not offer even minimal concessions to the United States in some cases. In those cases where Beijing did commit itself to written agreements, it was either unwilling or unable to implement the promised policies. China’s ability to resist American pressure is particularly puzzling in view of the fact that other similarly trade-dependent countries in Asia such as Japan, South Korea, and Taiwan have tended to be much quicker to offer concessions.” However, Zeng (2004, p.15) also concedes: “A near absence of trade wars has come to characterize U.S.-China trade relations.” He finds this particularly “puzzling”. (*ibidem*)

Zeng arrives at these conclusions using a mixture of case studies of trade conflict episodes between the United States and some of its most important trade partners and econometric regressions used to evaluate the probability of a trade war and their success.

He posits that “the more united interests are within the country issuing the threat, and the more divided interests are in the target country, the more likely that the party threatening sanctions will be able to get a favourable agreement.” (Zeng 2004, p.38) A lot would depend on the type of trade prevailing between each of two trading partner nations or trading blocs. Trade could either
be complementary or competitive. “Trade complementarity/competitiveness refers to the extent to which two countries engage in the production and export of a similar range of commodities.” (Zeng 2004, p. 42) His analysis would suggest “that the structure of trade has an important impact non domestic interests in the country issuing the threat: U.S. threats to impose economic sanctions will enjoy more unified domestic support and hence will be more credible when the target has a competitive, rather than complementary, trade relationship with the United States.” (Zeng 2004, p. 47) “In the case of competitive trade, domestic interest groups are generally unanimous in support of aggressive trade negotiation strategies, since both exporting and import-competing interests gain from aggressive tactics that promise benefits whether the threat succeeds or fails (and results in sanctions).” (Zeng 2004, p. 51)

Although this trade complementarity versus competitiveness as trade structure definition smacks a lot of intra-industry trade intensity degree, he sticks to “the number of overlaps between the top twenty commodities the United States exports to and the top twenty commodities it imports from major U.S. trading partners.” (Zeng 2004, p. 44) This seems to be a quite primitive measure in comparison with a proper index of intra-industry trade degree/intensity.

Drawing primarily on the database on Section 301 cases, Zeng (2004, p.54) shows with the assistance of some descriptive statistics, multi-variable econometric regressions and case studies “that substantial differences exist in the effectiveness of American pressure across countries and that these differences cannot be readily explained by the degree to which the target countries are dependent on the U.S. market for exports. Rather, trade competitiveness/complementarity better predicts the variations in threat effectiveness.” He “also looks at the record of trade conflicts initiated by the United States and shows that trade wars have taken place more frequently between the United States and its competitive trading partners and that regime type is irrelevant to understanding patterns of trade war.”

This view is apparently not shared by Paul Krugman. In his widely used textbook (Krugman & Obstfeld 2003, p. 141) he remarks that [t]here is both a good and a bad side to this favourable view of intraindustry trade. The good side is that under some circumstances trade is relatively easy to live with and therefore relatively easy to support politically. The bad side is that trade between very different countries or where scale economies and product differentiation are not important remains politically problematic.” This seems to imply quite the opposite of Zeng’s hypothesis. Conflict would be less probable between countries whose trade structure overlaps, i.e. where intra-industry trade predominates.

Breuss (2004) analyses what he calls “mini trade wars” between the European Union and the United States and confirms both that trade wars can only be won by large and powerful countries and that in most cases both countries involved lose in terms of their respective welfare.
What are the odds of a trade war with China in the near future?

How eminent is really the “trade war threat”, that many\(^3\) ventilate these days?

Lawrence’s 2006 analysis concludes that “China’s trade policies are broadly supportive of a rules based trading order”, and that “it has only been involved in one dispute as a complainant (US steel safeguards) and two as a defendant.”\(^4\) Based on four years’ evidence since WTO membership, Sally (2006, p.206) concludes that China has exceeded all optimistic expectations: it has been an exemplary WTO citizen.”

Mallon & Whalley (2004) concluded that “China has thus far shown considerable reluctance to use her WTO membership to assert her rights.”

However, Hufbauer and associates (2006, p.77-78) foresee “decades of US-China trade friction” and a “long string of trade cases”.

Regarding recent events with China we should ask ourselves if the probability of trade conflict is not rising as the trade structure goes from complementary to competitive, as China becomes more competitive in the same products where the U.S. and E.U. excel. One contradictory element would be the fact that the conflict is starting in the complementary textile industry and not in the competitive one (like cars, electronics and the like). Either this is irrelevant, a result of recent sudden end of quotas, or a real contradiction of our hypothesis.

Some hypotheses to be developed and tested

- Similarity in economic and trade structure and size

Kennan & Riezman (1988) confirm our suspicion that “if one country is substantially bigger than the other, then the big country can expect to gain by starting a tariff war.”

The more similar the economic and trade structure between each pair of countries becomes the more prone they are to trade conflict.

- Market share gain – amplitude and speed

The greater the market share of a trade partner, and the quicker it gains market share, the more probable it becomes that it invokes a protectionist reaction by its trading partners.

- Intensity of intra-industry trade (IIT)

\(^3\) For many see the Financial Times editorial of March 24, 2006, “Trade war threat”.

\(^4\) One was initiated by the US in March 2004 relating to preferential value added tax for domestically designed integrated circuits, and settled in October 2005, and currently there is a case regarding auto parts in which both the US and the EU allege China has violated its commitments. (Lawrence 2006, p.11)
A lot has been written about ways to measure IIT and its determinants, in general and on China itself. A recent example, as the paper by Zhang and co-authors (2005) confirmed the increase of China’s IIT with most of its partners in the observed period from 1992 to 2001, particularly Vertical Intra-Industry Trade (VIIT). VIIT has been found to be positively related to differences in consumer patterns and HIIT negatively so. Geographical distance, economic size, trade openness and trade composition have been confirmed as significant IIT drivers. Foreign direct investment (FDI) and Hong Kong (HK) have been ascribed an individual role in the increase of IIT intensity.

As an alternative or as complement to the trade structure similarity hypothesis IIT intensity could also be recruited as possible explanation for the trade conflict risk increase.

Lobbies representing consumer and more importantly producer interests are recognized of paramount importance in the definition of trade policy most decisively in democratic countries. Grossman & Helpman (1994) can be regarded as the seminal paper of this approach, which Baldwin & Robert-Nicoud (2006) have recently tried to make easy.

Propensity to trade conflict would then also depend on the organization capacity of industries affected by imports from the partner countries. “Rates of protection should vary positively with the stake of the specific factor in trade policy relative to that of the average voter (i.e., with the ratio of output to imports) and inversely with the sizes of the elasticities of foreign export supply and home import demand.” (Grossman & Helpman 1995) These authors go on concluding that “[w]hen both [home and foreign interest groups] are equally strong, their political influences will cancel, and international prices under a trade agreement should be equal to those that would prevail under totally free trade.” Or under a totally un-free trade…

- Retaliation and the spiral of conflict
A long way has been made by international trade research since the seminal paper on the subject by the late Harry G. Johnson in the fifties. Meanwhile, the “benevolent server of the national interest” was transformed in a more ambivalent government, whose trade policy “does not necessarily give rise to aggregate welfare maximization.” (Grossman & Helpman 1995) This would apply when trade negotiations succeeded, i.e. end up in an agreement. Welfare maximization would be probably a lot less likely if trade talks degenerate in trade conflict. Successive retaliations may achieve just that.

However, the possibility of exceptions and paradoxes might not be ruled out, in as much as “a government that is unresponsive to the public interest might actually serve the general voter well, because the self-interested government can credibly commit to a policy of aggressive support for the domestic industry”, as Grossman & Helpman (1995, p.694) admit.

The threat of retaliation and real retaliation can be seen as a “powerful instrument for encouraging cooperation from trading partners”, or as “defensive non-cooperation” (Baldwin 1990, 108-121). However, it can also easily lead to full-out trade war or become ineffective, if we don’t take care that it reduces “the foreign and domestic lobbyists’ incentives to lobby for tariffs.” Baldwin reminds us that instead of retaliating against all foreign industries - perhaps the first best solution – countries should settle for a rule of thumb, that would only apply to industries with intra-industry trade: “the retaliation should be against the foreign industry which benefited from offending tariff.” (Baldwin 1990, 109-110)

Another venue worth exploring could be the work reviewed by Garfinkel & Skaperdas (2006), that are busy trying to identify the effects of conflict on economic outcomes and “how conflict and appropriation can reduce the appeal of trade”. Alliance formation and the importance of intra-alliance commitments, e.g. between the US and the EU, eventually distorting incentives in the presence of conflict, and the role of governance in conflict management could prove interesting in the context of our research.

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