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Can China be Trusted?

If you've so much as glanced at a news site in the last month or two, you've seen the headlines; Tariffs and Trade Wars. Do tariffs ever make sense and have they ever worked? What has resulted from trade wars in the past? What kind of an opponent is China in international trade? What would it take to win at tariffs? This month, we examine these questions in The Investment Letter.

History of Tariffs and Trade Wars

The unilateral imposition of tariffs can be interpreted as a show of strength, unity, and resolve for US commercial interests, but, to borrow a familiar phrase from science – every action provokes an equal and opposite reaction. America's economy may be the strongest in the world, but our trading partners can and will retaliate against tariffs imposed against their goods. Consider this historical precedent: In the midst of the Great Depression, lawmakers, seeking to alleviate the pain of their constituents, passed the Smoot-Hawley Tariff Act of 1930. The Act unilaterally raised duties on hundreds of imports, focusing mainly on agricultural imports from Europe, which were hurting the US farming base as it recovered from the increasing competition and price-pressuring overproduction that followed WWI. After President Hoover signed the bill into law, America's trading partners followed suit with their own tariffs, and international trade fell over 60% between 1929 and 1934. Subsequently, FDR began the push to undo the damage of Smoot-Hawley with the passage of the Reciprocal Trade Agreements Act in 1934, which set the stage for later free trade initiatives such as the General Agreement on Tariffs and Trade (GATT), the North American Free Trade Agreement (NAFTA), and the World Trade Organization (WTO).

Today, the WTO reduces trade barriers, manages international trade rules, and settles trade disputes for its 159 member countries, and more than 98% of world trade flows through the WTO. But, a key agreement for inclusion into the WTO is that its members assign each other "Most Favored Nation" status, which means low tariffs. Studies have shown that the WTO has increased trade among its members, providing some stability for export levels and increased trade between countries who are not adjacent to each other. Also, since WWII, as a whole, the benefits received by the US by the opening of other markets to US goods have far outweighed the costs of opening US markets to foreign goods.

What kind of an adversary is China?

When it comes to complying with international trade agreements, China has a record that suggests it just doesn't play fair. To win entry into the WTO in 2001, China made commitments that seemed to signal its movement toward market-based economic principles, free trade, and globalization. However, a recent ITIF (Information Technology & Innovation Foundation) report found otherwise when it said that a "yawning gap" separated China's economic

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and trade policies from those commitments dating from 17 years ago.

The ITIF found that while China had reformed many of its laws and had met "many of its WTO commitments," its economic and trade policies had failed to embrace globalization and the tenets underpinning the mission of the WTO. Perhaps the most damning, the report points out that while China pushes back at reforms that would open its markets to globalization, it exploits reforms that open the markets of other countries to its goods. As examples, the report cites China's failure to open its telecommunications market to competition, its manipulation of its tech standards in order to thwart competition, and the subsidies it provides to artificially bolster the competitiveness of its exports.

Indeed, the 2001 celebrations lauding an end to China's insular, protectionist principles of economic isolationism now seem, 17 years later, erroneously optimistic.

China understands few things, but force is one.

While China was admitted to the WTO on the idea that this signaled a move toward western-style economic policies, this has largely failed to materialize. Instead, China has expertly exploited its status as a developing country and illegally appropriated proprietary technologies through forced joint ventures and, in some cases, outright piracy of technology.

China does not see eye-to-eye with the US on free trade. But, China does understand force. They have retaliated with reciprocated tariffs targeting US farmers and other industries located in areas that have had the support of the lawmakers backing the US tariffs. China can also interfere with US firms operating on Chinese soil.

Where we stand now.

China cannot hold out forever. While the US may sustain some commercial damage from a trade war involving escalating tariffs, China is already starting to show some strain. Since tariffs were first announced in January, China's stock market has tumbled some 25% while the S&P 500 has been hovering at record highs. That seems to indicate that investors think the US will eventually come out on top. The Chinese Yuan has also experienced pressure amidst talk of a trade war, as has the Chinese economy in general. The pace of growth of the Chinese economy has been slowing to rates not seen since 2016.

Where do we go from here?

In the short-term, tariffs exert the pressure that China understands. But, they are not a long-term solution. Tariffs will not restore a manufacturing base in the US that long ago left during the early days of globalization. Very often, trade wars generate much more controversy and speculation than wins for the general public. While they may prove themselves as worthy negotiating tactics in the short-term, quite often, in the long-term, they do little else than raise prices on the foreign goods that markets otherwise would prefer, forcing consumers to pay an additional tax or settle for an inferior domestic good. Simply put, the risks stemming from a trade war with China are great when they do not embrace free trade and will gladly subsidize their domestic industries to provide them with artificial advantages within and outside their markets.

Tariffs can serve as a catalyst to get true, good-faith trade negotiations going, but they are a means to an end, and not an end per se. In the long-run, we need the negotiation of effective trade deals that provide mutual benefits that motivate both sides to "play fair", rather than the threats, strong-arming, and questionable success offered by tariffs on their own. A trade war, like any other war, should be avoided until all other reasonable avenues have been exhausted.

History tells us that China believes, an agreement is nothing more than pause in negotiations. ■