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Trade wars and Asia

Roberto Azevêdo Overlooked successes of global trade governance

Mari Pangestu and Christopher Findlay A case for regional leadership

Amitav Acharya Asia after the liberal international order

Yao Yang Another messy falling-out in US-China relations ... **and more**

ASIAN REVIEW – Dan Slater: Malaysia's modernisation tsunami

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From the editors' desk

The world's two largest economies and trading nations are skirting around the brink of a trade war. This puts at risk the international trading system that underpins prosperity in the global economy.

The US administration's America First agenda has brought uncertainty, and the risks have intensified in President Donald Trump's second year in office with the tariffs he slapped on steel and aluminium imports and the threat of large-scale protection aimed at China. The European Union, China and others have threatened to retaliate as the US measures are implemented.

A managed trade deal between China and the United States currently looks a likely outcome. Although it might be better than a full blown trade war, it will involve measures outside of the rules-based order. That would have significant negative spillovers to other countries, diverting trade and investment in ways that diminish global welfare and exacerbate political tensions. Nor will it reduce the United States' trade deficit.

More than any other region, Asia relies on open markets and confidence in the multilateral system for economic and political security.

Adjusting to China's rise was always going to be difficult to manage for the United States, its allies and the established order. But President Trump has raised the stakes and multiplied the risks.

If Trump is intent on tearing up the existing global economic order, how might the rest of the world respond, preserve what works and fix what doesn't work without major disruption?

The essays in this issue of EAFQ bring together analysis from the region's top thinkers on the evolution of, and changes in, the US–China relationship, the threat to the global order and what options exist for moving forward.

The shift away from US leadership in trade, what needs to be done to rebuild the support for openness in America, Japan's difficult position, the Brexit ordeal, and Asia's response are all featured in this issue.

The regular Asian Review section includes essays on Malaysia's democracy and modernisation, Chinese governance and a deep dive into the US–China economic relationship.

Shiro Armstrong and Jenny Gordon

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Social, not trade protection promotes prosperity

COVER: US President Donald Trump holding a signed memorandum on intellectual property tariffs on high-tech goods from China, at the White House on 22 March 2018. Picture: Jonathan Ernst, Reuters.



Behind-the-scenes preparations for a meeting between Chinese Transport Minister Li Xiaopeng and US Secretary of Transportation Elaine Chao in Beijing in April 2018.

Asia after the liberal international order

AMITAV ACHARYA

WITH the election of Donald Trump as President of the United States, the West suddenly woke up with an acute anxiety about the fate of the US-led liberal international order. Until then, the liberal establishment in the United States had assumed that Hillary Clinton would succeed Barack Obama as president and ensure continuity in the liberal

order. They ignored or dismissed warnings about the order's crisis and decline. The belief in the resilience of the liberal order changed dramatically on 6 November 2016.

What is the liberal order? It is an international system created and managed by the United States after World War II to promote capitalism and democracy through building alliances and multilateral institutions. Its supporters portray the liberal

order as an open, rules-based and multilateral system that operates through consent rather than coercion.

This is a fundamentally self-serving and distorted view. In reality, the liberal order is a club of the West. To other countries, its benefits—such as market access, aid and investment, and the provision of a security umbrella—were offered selectively and conditionally. Leading nations of the developing world, including China

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and India, were either outside of the system or connected at the margins. Some developing countries were summarily excluded.

The order often operated more through coercion than consent. It was hardly ‘orderly’ for the Third World, where local conflicts were magnified by capricious great power intervention, including by the United States and its Western allies.

Trump’s rise proves that the challenge to the liberal order is as much from within the United States as from outside. Trump is not the cause of the crisis of the liberal order, but rather its consequence. The liberal order had begun to fray and fragment well before the Trump presidency due to irreversible structural changes in the global economy, especially the rise of China and other non-Western powers. Growth in world trade had slowed and the World Trade Organization had been moribund for some time. A sizable section of the US electorate was already disillusioned with free markets and free trade. While Trump was able to stoke and exploit these sentiments, their origins predate his political rise. Trump’s policies are pushing the liberal order closer to the precipice. He is severely weakening the US commitment to free trade and multilateralism, and his elevation to the US presidency is encouraging populist and authoritarian rulers around the world. Trump shows more interest in engaging Putin and Kim than Merkel and May.

Asia was a grey zone of the liberal order for much of the post-World War II period. Some countries of the region, especially the so-called ‘East Asian tigers’, benefited from export-led growth strategies and access to the US market that the liberal order facilitated. But East Asian capitalism

was mediated by the strong hand of the state. Democracy in the region was scarce and illiberal, marked by one-party rule, sham elections and scant provision of civil liberties. The United States discouraged the development of regional multilateral institutions in Asia in favour of a hub-and-spoke system of bilateral alliances. ASEAN—the most successful regional multilateral institution in Asia—was established with no help from the US. It came about despite the liberal order, rather than because of it.

Trump’s effect on the liberal order might not be known for some time. At this point, we do not know how long his presidency might last, whether he will face impeachment or seek re-election—and if he does, whether he would win a second term. His approach to foreign policy is so inconsistent (such as his reversals on the Trans-Pacific Partnership) that one must exercise extreme caution in making any predictions about how his presidency might eventually affect the world order.

THE vagaries of the Trump presidency notwithstanding, the liberal order is facing an existential challenge. Elements of the liberal order will survive but the order will not enjoy the dominance it once claimed for itself. The era of liberal hegemony is past. The rise of the rest is real.

Asia has come a long way since the Cold War. China and India, the region’s leading powers, have embraced economic openness. There is now a range of multilateral institutions in the region, centred around ASEAN. But the great powers of Asia will not be the saviours of the liberal order, as some hope.

While China has pledged to support the liberal order, this is likely only in reference to some of its economic

QUIET VICTORIES

and institutional aspects, especially the flow of trade and investment. China will not support the political foundations of the liberal order, such as democracy and human rights. Even in the economic arena, China's policies—such as the Asian Infrastructure Investment Bank and the Belt and Road Initiative—will alter global trade, investment and development patterns even if they are only partially successful. In the longer term, they will create a Chinese-led international order over Eurasia and beyond.

Instead of helping the West to resurrect the liberal order, Asia will lead the transition to a different type of world order. The remnants of the liberal order will have to come to terms with a Chinese-led order and other regional orders around the world in what I call a decentred and post-hegemonic 'multiplex world'.

Such a world will not be free of conflict. But conflict will be tempered by both older and newer forms of interdependence and institutions across regional orders, including those responding to shared transnational challenges such as climate change, pandemics and terrorism. This outlook is more plausible than the doomsday scenarios of disarray and collapse that many liberal pundits in the West have imagined as a result of the end of the US-led order. They were wrong before and are likely to be wrong again.

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The overlooked successes of global trade governance

ROBERTO AZEVÊDO

THE rising trade tensions of recent months have grabbed the headlines—and rightly so. But what you don't often hear about is how well the global trading system has performed over the years. You could argue that global trade governance has actually been the quietest success story of the post-war era. It's important to remember what we could stand to lose if the current tensions lead to an unmanageable escalation of tit-for-tat actions.

The multilateral trading system, as embodied in the World Trade Organization (WTO), has been

very effectively doing the job that it was created to do for many years. It has secured a foundation on which countries can base their economic planning with confidence—so much so that countries sometimes appear to take the stability and predictability of the trading system for granted in their economic planning. I deal with trade ministers on a daily basis, but it's rare that I have a finance minister on the phone asking about the outlook for the global trading system. It is assumed that the system is a simple fact of life. Yet with goods and services exports representing 28 per cent of global GDP this is no small part in the shaping of economic plans and strategies



WTO Director-General Roberto Azevêdo: trade is playing its part in ensuring world prosperity.

PICTURE: WORLD TRADE ORGANIZATION

for economies—large and small, developed and developing.

Imagine, however, if we were suddenly presented with a scenario where the system started to falter. If tariff levels were no longer bound at the historically low levels we see today, if we could not rely on members honouring their services commitments, or if the system of settling trade disputes was to erode, the consequences would be dramatic. If, for example, tariffs returned to the levels before the multilateral trading system was created we would see trade flows fall by 60 per cent, while the global economy would contract by 2.4 per cent. That's even bigger than the contraction after the 2008 crisis—the biggest crisis we've seen in the past 80 years. It's an extreme example, but shows just how important the trading system is.

Despite the tensions between major trading partners, trade is actually performing very well and helping to drive the global economic recovery. Global merchandise trade grew at a rate of 4.7 per cent in 2017—the strongest performance since 2011. With economic cycles between China, the United States and the European Union re-synchronising in a way that we have not seen for a decade, we expect this growth to continue. We estimate that world merchandise trade volumes will grow by 4.4 per cent in 2018, and around 4 per cent in 2019.

This outlook is good news. It means that trade is playing its part in supporting growth, development and job creation.

But of course all of this could be at risk if the tensions that we have been seeing continue to escalate. The global economy is profoundly interconnected today, and this multiplies the complications that trade-restrictive actions can cause. Two-thirds of world

trade now occurs through global value chains. As the economist Richard Baldwin argues, erecting trade barriers in today's economy is like building a wall in the middle of a factory. And in an interconnected economy, the effects of any shocks to the trading system would likely be globalised, reaching far beyond those countries that are directly involved. In this scenario everyone would be affected, and poor countries would stand to lose the most.


Global cooperation will be essential in easing these tensions and safeguarding the strong growth that we are seeing today. The WTO, which was created as a forum for members to find ways to cooperate and hold each other to account, will play its proper role in this process. Indeed, we have done so before. It can be argued that without the WTO, a wave of protectionist measures would have been stirred up by the 2008 crisis, significantly worsening the economic effects of that downturn.

While the multilateral trading system is important, it must also be continually strengthened and improved so that it can meet the demands of a rapidly changing and evolving global economy—and in recent years WTO members have succeeded in delivering a number of important reforms. Major breakthroughs include the 2013 Trade

Global cooperation will be essential in easing these tensions and safeguarding the strong growth that we are seeing today

Facilitation Agreement, the 2015 agreement to eliminate agricultural export subsidies, and a series of steps to support the WTO's least-developed members. In 2015, a group of members struck a deal to expand the Information Technology Agreement, which eliminates tariffs on a wide range of information technology products.

At the WTO's Ministerial Conference, held in Buenos Aires in December 2017, members took further steps. For example, they committed to securing a deal on fisheries subsidies which delivers on Sustainable Development Goal 14.6 by the end of 2019, they agreed to extend the practice of not imposing customs duties on electronic transmissions for another two years, and they agreed to continue negotiations in other areas including agriculture, services and market access. Groups of members—encompassing participants from developed, developing and least-developed countries—announced new initiatives to explore talks at the WTO on the issues of electronic commerce, investment facilitation, micro-, small- and medium-size enterprises and women's economic empowerment. Work on all of these fronts continues in Geneva.

These efforts to reform and improve the trading system are vital, but we should also remember the inherent value of what we have. Cooperation on trade, through the WTO, is fundamental to the global economy as we know it today. This cooperation is a precious resource—and in the years to come I will be working to ensure that we see more of it, not less. 

Roberto Azevêdo is the Director-General of the World Trade Organization. Follow him on Twitter: @WTODGAzevedo



The core of an anti-protectionist partnership? South Korea's President Moon Jae-in, Chinese Premier Li Keqiang and Japan's Prime Minister Shinzo Abe at the three-nation business summit in Tokyo on 9 May 2018.

A coalition for openness in Asia

SHIRO ARMSTRONG

PRESIDENT Trump's America First agenda is a dramatic departure from US leadership of a multilateral order that has been the guiding norm for over 70 years. That order defines the rules of trade and economic exchange between countries that have signed on to it through the World Trade Organization (WTO) and other international institutions. While sometimes imperfectly observed, these

rules have underpinned the growth in Asian economic relations and prosperity.

Economic relations between Japan and China have prospered hugely despite the ups and downs in their political relations because of both countries' adherence to WTO rules. Economic relations would unravel all over Asia if confidence in the WTO-led rules-based order was undermined. Trade disputes, like that between Japan and China over rare earth metals

in 2012, are settled appropriately and peacefully in the WTO without resort to retaliation, escalation or force.

US tariffs on steel and aluminium imports to protect American steelmakers and, putatively, to reduce trade deficits, as well as other protectionist measures aimed at China, may not have large, immediate economic effects but they pose a bigger and long-term threat to the entire global rules-based system.

Many countries have received

exemptions from the US steel and aluminium tariffs. By accepting those exemptions, they have failed their obligations to the rules-based order. These choices will become starker as the United States continues down its chosen path of extra-WTO tariff action, and as other countries are pressured to retaliate. The price for an exemption for Japan seems to be negotiation of a bilateral deal with the United States that would likely include many non-economic issues. Japan has rightly chosen not to be coerced in that way.

The United States and China—the world's two largest economies and traders—are on the precipice of a tit-for-tat trade war that could spiral out of control. It is a high-risk game for which the 'best' outcome is a bilateral settlement towards managed trade involving voluntary export restraints and other measures inconsistent with the multilateral system. Yet this outcome would mean large negative spillovers to other countries. That would pressure other countries to 'protect' markets and also empower protectionists globally. Asia cannot afford to see beggar-thy-neighbour policies and the contagion of protectionism take hold.

A worst-case outcome is an all-out global trade war that would

Asian leaders, headed by Japan and China, need a bold commitment to resist protectionism

undoubtedly lead to global recession. That did not seem a plausible scenario two years ago, but it certainly is now.

The threat to the global trading system will only be met by a concerted response by other stakeholders in the global trade regime. Such a response needs coordination and strategic action that doubles down on the rules-based global system. As the world's largest trader and second-largest economy, China has more to lose than most, but it also has the weight and interest to hold the line. China will find it too difficult to avoid retaliation against provocation if it acts alone, but China's banding together with the global community to resist the escalation of protection may work. Japan, Australia and others will need to be part of a coalition of open economies in that endeavour.

Since President Trump withdrew the United States from the Trans-Pacific Partnership, Japan led the remaining 11 members to conclude TPP-11, the rebranded Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) in March 2018. Australia played an important role in the TPP-11, as well as leading the pushback against Trump's team tearing up multilateralism as APEC's central tenet at the summit in Vietnam in November 2017. But that's just the start and much more will need to be done.

The most promising opportunity

to strengthen Asia's rules-based economic order is with the Regional Comprehensive Economic Partnership (RCEP)—an agreement being negotiated by the 10 ASEAN members as well as Australia, China, India, Japan, New Zealand and South Korea.

RCEP provides a natural opportunity to build an Asian coalition in defence of free trade and economic cooperation. The group includes some of the largest and most dynamic economies in the world and is important enough to make a difference globally. An Australian Productivity Commission study estimates that even if tariffs were raised by 15 percentage points globally (similar to what happened in the Great Depression), RCEP countries could all continue their economic expansion if they abolished tariffs as a group. The gains for RCEP countries would be even larger with behind-the-border reforms.

Asian leaders, headed by Japan and China, need a bold commitment to resist protectionism and to work with countries within the established WTO rules. Such an agreement would mean that countries were not alone when trying to avoid retaliation for moves against any American unilateral measures. Australia and other middle powers will be important in mobilising such a coalition. Not only would collective leadership in Asia give a boost to RCEP and other regional initiatives, it would help protect the global system and minimise the damage of a protectionist agenda.

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OUR NEXT ISSUE . . .

**Peak
Japan**



Feeling the pressure on the floor of the New York Stock Exchange. Talk of trade war has spooked financial markets.

China's response to Trump's 'trade war'

PETER DRYSDALE

TODAY the global trading system has entered an age of uncertainty: the multilateral rules-based trade regime is under assault and the liberal economic order that has underpinned trade growth and global prosperity is under threat from its chief architect, the United States. No response to this uncertainty is more important than that from China.

Some people think the difficulties in international economic policy that we face today all arose with the election of US President Donald Trump. That is an oversimplification.

Today's difficulties are a consequence of significant shocks to economic and trade systems through the global financial crisis as well as of long-term structural changes in the global economy that have been shaking the system for some time.

These changes include the emergence of China and its accommodation in the global system. In North America itself, there are long-term structural problems that are the origin of the maldistribution of gains from international trade on which Trump built his political claim to the presidency. Trump and many of his followers blame China

for these American woes, but most are structural problems of the United States' own making and their solution is in American hands alone. They require deep institutional and policy reforms in the United States and a different approach to social policy, as well as changes to international trade policy that extend and strengthen the rules-based system.

The notion that the United States has not reaped huge benefits and gains from international trade is false; US national income growth has been boosted significantly by the gains from trade. But the distribution of the gains from trade is poorly served by

domestic policies and institutions (in health, education, and by adjustment policies) and many households have not seen real incomes rise for decades. This will not change quickly, certainly not in a presidential term: it will take a generation to fix.

Trump has declared trade war to right the wrongs that he says the United States has suffered at the hands of its trading partners, notably China. He blames them for the US trading deficits. That, of course, is not the case. US trade deficits are a product of the United States spending more than it earns and covering the extra spending by importing capital in some form or other. There are issues to be negotiated with the rules of international trade and commerce (on foreign investment, technology trade and the digital economy), but they have little to do with righting international trade imbalances.

Trump's trade war is yet to be engaged, but if it is merely a negotiating tactic designed to shift the trading system forward, it is a costly and a risky tactic. His talk of trade war has spooked financial markets. His tax cuts will fuel spending, expanding the US trade deficit through lifting US spending on purchases from abroad. More importantly, his flouting of World Trade Organization trade rules and wrong identification of trade restrictions as the cause of US trade deficits blows the credibility out of US trade policy leadership, making it easier for other countries to tear down the system.

China's importance in the global economy is second only to that of the United States. Its response to US action on trade will be crucial.

'The mood in Washington has shifted from engaging with China to hedging against it', as Yao Yang argues on page 12. Technology competition


Asia has more at stake
in the global system
than any other part of
the world—its economies
depend on the open
rules-based system

is an underlying issue that now confronts the China–US relationship. The major justification for Trump's ill-advised declaration of trade war is Chinese 'theft' of US intellectual property and 'forced technology transfer'. Punitive tariffs are just the warm up for a coming 'marathon in technological competition'. In the years ahead, it is highly likely that the Trump administration will tighten up its control on Chinese companies' merger and acquisition activities in the United States' (page 13).

Measures to transfer technology through investment policy have been part of policy to promote industrial development across all the 'catch-up' countries, including Japan and South Korea as well as China. Historically, the United States played the same game. So too have state-led industrial policies to promote technological advancement. The additional dimension in China's case is the alleged state-mandated theft. All of that needs to be negotiated and now needs to change. But none of it recommends tearing down the global trading system. The priority should rather be upon investment facilitation, an investment agreement that deals with these issues, and building a multilateral-based international digital economy regime.

Chinese policymakers need to recognise the change of policy psychology in Washington and form a new strategy to deal with the United States. The right long-term response is to continue China's reform and opening policy, which has been critical to its 40 years of high growth, and to demonstrate that response through immediate action.

For the rest of the world, this is a time when wait-and-see strategies are no longer viable. It is a time that requires strategic response, particularly from partners in the Asian region. China cannot frame the right response alone.

Asia has more at stake in the global system than any other part of the world—its economies depend on the open rules-based system not only for their economic prosperity but also for their political security. The appeal to the rules-based system is a critically important dimension of protecting economic security and of political security more broadly. Asian countries need to stand firm in the face of the threat to the global trade regime. The dynamic of Asian growth depends importantly upon remaining committed to the trade reform agenda and encouraging entrenchment and deepening—including by China, the Southeast Asian economies and India—of the open rules-based international trading system. 

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Another messy falling-out in US-China relations

YAO YANG

IN 2004 US Nobel Prize-winning economist Paul Samuelson published his last academic paper to tell the world that China's technological progress might not be good news for US workers. His contention was that if China improved its labour productivity on goods that China was already exporting to the United States, then the United States

would benefit. But if China began to improve its labour productivity on goods that the United States was producing and was then ultimately able to replace US companies in producing those goods, then the United States would lose because that would suppress US wages.

Samuelson appeared more connected to reality than his contemporaries, most of whom were stern supporters of free trade. Ten

years after the global financial crisis, more US economists have begun to align with Samuelson, and the Trump administration has taken his idea into action.

When the Trump administration announced punitive tariffs on steel and aluminium in March, US allies rushed to Washington to ask for exemptions. Martin Feldstein—the veteran president of the National Bureau of Economic Research—put



Stocks information at a brokerage house in Jiujiang. China's economy performed better than most of the world after the global financial crisis.

PICTURE: REUTERS

it bluntly: in the end, every US ally would be exempted, and the only target remaining would be China. He sort of got it right—except for Japan, South Korea and the European Union, American allies did receive exemptions.

In pursuit of China, of course, steel and aluminium are not the end of the story—China's steel and aluminium exports to the United States are very small. More serious moves are now being taken in the name of Section 301 investigations. These investigations specifically target intellectual property violations, about which the United States has long complained to China.

The Trump administration has announced it will raise tariffs on China's exports worth US\$50 billion, most of which are in the high-tech areas. ZTE, one of China's high-tech giants, was banned from importing parts from the United States for seven years following the allegation that the company had not kept its promise to fire key persons involved in its deal with Iran. The US Justice Department has also announced that it is investigating Huawei, the crown jewel of China's high-tech industry, for criminal conduct. A technology 'cold war' seems to be looming over China and the United States. Although President Trump continues to call China a friend of the United States, the mood in Washington toward China has changed.

AFTER 20 years of animosity the United States restarted its contact with China in the early 1970s. President Richard Nixon's historic visit to China in 1972 opened a new chapter for US–China relations. The two countries walked together because they faced the same arch-enemy—the Soviet Union. On the US side, a 'rapprochement' policy was formed to

guide its relations with China, which ultimately led to the establishment of diplomacy between the two countries in 1979. The 1980s were a honeymoon period. The United States gave most favoured nation (MFN) status to China and tolerated China's mercantilist policies (such as dual exchange rates). There was also military cooperation between the two countries.

The honeymoon ended abruptly after the 1989 Tiananmen Square protests. The United States and its allies imposed an arms embargo on China. However, the administrations of George Bush Sr and, later, Bill Clinton, did not isolate China. Instead, a new 'engagement' policy was fashioned. The belief behind this policy was that, by engaging China, 'China will become more like us.'

Economic integration was the cornerstone of the policy. In 1995, then-president Clinton delinked China's MFN status from its human rights record. In 2001, then-president George W Bush signed the agreement to take China into the World Trade Organization. This was a critical step in unleashing China's export potential, which was supported by millions of low-wage but relatively well-educated workers. In the next seven years China's exports increased five-fold.

The winds began to change after the global financial crisis. The Chinese economy performed much better than the rest of the world, mostly thanks to its swift monetary and fiscal responses. Over the past decade China has quickly narrowed its gap with the United States in terms of GDP. Relying on its newly acquired wealth, China began to take a more active role on the international stage—and that set alarm bells ringing on the American side of the Pacific.

To US elites, China's sovereign claims in the South China Sea violate

'freedom of navigation,' and China's expansion of development aid through a set of new financial instruments (such as the Asian Infrastructure Investment Bank, the New Development Bank and the Silk Road Fund) shows that it intends to set up a new financial system that is parallel to the Bretton Woods Institutions. Most of all, US elites are worried that China is exporting its political system alongside its development aid. This fear seems to have been reinforced by the political changes that have happened within China. In a nutshell, US elites now seriously doubt that 'China will become more like us.'

The mood in Washington has shifted from engaging with China to hedging against it. US elites no longer care about what is happening inside China, be it economic liberalisation or human rights violations. They only care about how China impacts on the United States. The Chinese bargaining chips that used to please the United States, such as small steps of market opening and large purchases of US goods, do not work anymore.

THIS was clearly shown by the demands that the US delegation put on the table when it visited China on 3–4 May: lower tariffs to US levels, stop subsidies to 'Made in China 2025', get rid of the US\$200 billion trade surplus with the United States by 2020, announce the negative list for foreign investment by 1 July 2018, ensure no retaliation to the United States' punitive tariffs, and hold a meeting with the United States each quarter to evaluate China's progress. To China, these demands are either 'mission impossible' or a call for China to submit to US imperialism. There is no reason to believe that US delegates did not have an understanding of China's possible reaction beforehand. They

wanted to present their demands as a take-it-or-leave-it offer.

The two sides have engaged in busy discussions (among the most recent have been China's Vice Premier Liu He's visit to Washington and Commerce Secretary Wilbur Ross's visit to Beijing). There is still hope for them to settle their disagreements, including the sanctions on ZTE. However, a marathon in technological competition between the two countries is unlikely to be avoided. In the years ahead, it is highly likely that the US will tighten up its control of Chinese companies' merger and acquisition activities in the United States (Congress has already introduced several acts to restrict China's technological acquisitions in the US). This will remove one of the most important channels for China to upgrade its technology.

On the China side, it is imperative for policymakers to recognise the change of attitude in Washington and form a new strategy to deal with the United States. A more domestically oriented policy is needed. Announcing retaliatory tariffs is a short-term response. The right long-term response is to continue China's reform and opening policy, which has been critical for China's 40 years of high growth. This was exactly the message sent by President Xi Jinping in his Boao speech on 10 April.

Reform and opening will not only defeat Trump's excuse for the trade war, but also create conditions favourable for China's technological upgrading. 

Yao Yang is Dean of the National School of Development, Director of the China Center for Economic Research, a Cheung Kong Scholar and a Boya Chair Professor at Peking University.

Experts back tough US stance on China

CLAUDE BARFIELD

THE Trump administration holds a great many economically erroneous and politically demagogic views on trade—that trade policy can change trade balances, that bilateral agreements are more economically efficient than regional or multilateral agreements, that US national security is imperilled by steel and aluminium imports, and that the US trade deficit is conclusive evidence of 'unfair' trade practices. Hence, it is difficult to accept that on China, Trump's goals—if not his tactics—are in the US national interest.

It is surprising how many critics of the administration's foreign and domestic policies support the United States' finally taking a hard stand on emergent Chinese mercantilist protectionism. Prominent political commentators such as David Ignatius and Fareed Zakaria have joined respected economic analysts such as Greg Ip of *The Wall Street Journal* and Robert Samuelson of *The Washington Post* in agreeing, in Zakaria's words, that 'Trump is right: China's a trade cheat'. Douglas Irwin, the distinguished US trade economist and historian, has recently argued that one cannot 'really defend the way China has moved in the past few years, violating intellectual property and forced technology transfer'.

While there is general agreement

across a wide spectrum that China's discriminatory state capitalism must be challenged, there is less agreement on how and when to proceed. There are two general schools of thought on mounting a challenge. One group argues that the United States should rely heavily on the World Trade Organization (WTO) and should proceed only as part of a coalition of the willing. A second group supports using the WTO and working with trading partners but is also willing to support unilateral action by the United States in parallel with potential joint efforts.

Under the latter group's suggestions, the Trump administration should proceed with its proposed bilateral negotiations with Beijing, though the threat of 25 per cent tariffs to reduce the US trade deficit is a mistake. Rather, the administration should invoke Section 301 of the 1974 Trade Act with an emphasis on areas where WTO rules do not extend. The priority should be a focus on the complex heart of Chinese mercantilist policies—namely Beijing's disregard for intellectual property and its IT protectionism. These joint issues have manifested themselves as forced technology transfers, discriminatory practices against foreign patent and copyright holders, sweeping definitions of national security in the Chinese national security and cybersecurity laws that allow for

anti-competitive practices, exclusion of foreign investment in numerous sectors, forced data localisation and cloud service restrictions, and special privileges and subsidies for Chinese state-owned enterprises.

Should Beijing's leaders refuse to make major reforms in China's mercantilist system, then the United States should reciprocally move to exclude Chinese participation in the US economy through investment and capital-market restrictions. Employing investment restrictions and using Section 301 for policy areas not covered by WTO rules will lessen the potential that the United States itself runs afoul of the WTO.

Paralleling these bilateral negotiations, the United States should mount a sustained effort to enlist the support of key trading partners. The European Union and Japan will be key allies: both have signalled that they would join a coalition against Chinese protectionism. These issues are especially urgent for the European Union, as the continent is struggling with a wave of state-directed Chinese

incursions into key technology areas. Canada, South Korea and India offer themselves as other potential partners in this endeavour.

This is not to say that Washington should ignore the WTO. International legal scholars differ over the extent to which WTO rules extend to alleged Chinese trade and industrial policy practices. Even those urging maximum utilisation of the WTO admit (given that the last WTO negotiations ended in 1995) that key issues related to digital trade and information technology are not covered. But the United States and its trading partners can and should still challenge China in the WTO for a number of potential violations.

A direct challenge to China's Great Firewall (censorship) system is one such avenue. China tends to justify its censorship by a bogus invocation of the WTO rules' 'public order' exceptions, and there is some case law indicating that WTO panels look on such arguments with disfavour. As a result, they may be sympathetic to reining in China's closed internet

platforms.

Another avenue comes from former WTO Appellate Body member James Bacchus, who advocates that the United States should mount a systemic attack on China's intellectual property system as a whole. Unusually for WTO rules, the intellectual property agreement mandates an affirmative requirement to enforce obligations with effective remedies against infringement. There is a strong argument that Beijing's procedures and laws do not fulfil these responsibilities.

Finally, the United States could invoke the rarely used 'non-violation nullification and impairment' clause of the WTO Dispute Settlement Understanding. This clause allows for dispute resolution mechanisms to be invoked if one WTO member nullifies a benefit that another member could have reasonably expected before entering an agreement. The United States could argue that it is being denied market access benefits that it could have reasonably expected when it assented to China's membership in the WTO, since such benefits have been systematically undercut by persistent Chinese mercantilist policies.

Chinese state capitalism has evolved into a complex, all-encompassing system that is buttressed by myriad market-inhibiting practices and regulations. Random tariffs will not effect change. Change—if it comes at all—will be the result of a comprehensive strategy (hopefully with trade allies) that combines negotiations, case law, and ultimately the threat of retaliation. **EAFQ**

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Visitors through the ZTE trade stand at the ITU Telecom World 2015 exhibition. The firm has been one of the Chinese IT companies marked for sanctions by the Trump administration.

PICTURE: I. WOOD / ITU PICTURES



President Trump boarding Air Force One in Vietnam. His threats have 'undermined the United States' credibility' as a defender of free trade.

Taking up the challenge in US-China economic relations

JOSHUA P MELTZER

DURING the presidential campaign, candidate Donald Trump singled out Chinese trade practices as a key concern. Once in office many of the threats he made against China, such as labelling it a currency manipulator and imposing 30 per cent tariffs, did not come to pass. But this is changing as dealing with China increasingly assumes centre stage for the administration.

The approach of the Trump

administration to the challenges posed by China's trade and investment practices has so far been clumsy and often counterproductive. Dealing with the China challenge effectively requires much more effort at bringing allies along. It also requires recognition that the rules-based trading system—grounded in the World Trade Organization (WTO) and free trade agreements (FTAs)—is key to creating the normative and economic pressures that are needed to encourage China to reform.

The first year of Trump's presidency seemed to hold out the potential for significant disruption to the international trading system. Yet despite threats to withdraw the United States from the WTO and the North American Free Trade Agreement (NAFTA), and to impose tariffs on China and others, there was little follow-through. While Trump did withdraw the United States from the Trans-Pacific Partnership (TPP), the agreement had yet to be ratified. Because of this, US withdrawal—

though regrettable—caused less of a systemic shock than would be the case if the United States withdrew from the WTO.

Moreover, 2017 also witnessed the conclusion of several significant trade agreements, in particular the Canada–EU and Japan–EU pacts. The TPP countries also reconstituted the agreement without the United States as the Comprehensive and Progressive TPP (CPTPP), which was signed in March 2018.

While encouraging, this spate of agreement conclusions could be the breaking of the last great wave of trade liberalisation. All of the agreements concluded last year were started during the Obama era. And somewhat ironically, an important driver for concluding these agreements was the response to the uncertainty caused by Trump's threats to withdraw the United States from the WTO and NAFTA.

Since Trump was elected no major new trade initiatives have commenced or are likely to start. Trump's offer at the APEC Leaders Meeting last year to negotiate bilateral FTAs with countries in the Indo-Pacific has largely gone unheeded. In fact, key countries such as Japan with which the United States would like to commence bilateral FTA negotiations have failed to take up the offer. Under previous administrations, countries tended to queue up for the prospect of concluding a bilateral FTA with the United States.

The only significant trade negotiation under way that involves the United States is the renegotiation of NAFTA. This negotiation is proceeding slowly in the face of US proposals that neither Canada nor Mexico are willing to accept, such as a five-year sunset on the term of the NAFTA unless the parties agree for it to continue, and rules of origins on

autos that would require such large increases in US domestic content that it would upend North American supply chains and reduce the competitiveness of the auto sector.

Having withdrawn the United States from the CPTPP and outlined a preference for bilateral FTAs that has yet to find willing partners of any significance, US trade policy has become focused on addressing the trade and economic challenges that China presents the United States and the global trading system more broadly.

That China's trade and economic practices pose real challenges to the existing trading system is a view deeply held within the US administration and has traction in the US Congress and the private sector.

The China challenge is both economic and strategic. China is using its growing economic weight to alter trade and investment rules in its favour and to generate regional outcomes often contrary to US interests. China's Belt and Road Initiative uses massive amounts of Chinese investment to link the region with (and increase its dependence on) China, and to create new regional trade and investment rules.

That China's trade and economic practices pose real challenges to the existing trading system is a view deeply held within the US administration

China is also using its economic clout to punish countries that act against its interests (and often in support of US goals). China reduced trade and tourism with South Korea over the latter's decision to install a US anti-ballistic missile defence system in response to North Korean aggression. China is also undermining ASEAN unity by offering loans and other economic inducements to ASEAN member states, particularly Cambodia. China's influence over some ASEAN countries is preventing ASEAN from reaching consensus on key strategic issues of importance to the United States, such as China's reclamation of contested features in the South China Sea.

The China challenge is also difficult to address because the trade and investment practices that concern the United States are products of the Chinese political system. China's consolidation of and support for state-owned enterprises (SOEs) provides the Chinese state with tools of economic management, and thus the means to carry out the types of geostrategic goals outlined above. Where SOEs are not involved in overseas trade and investment activities, China's private sector is being harnessed to state-driven goals. For instance, in the technology sector China's National Medium- and Long-Term Science and Technology Development Plan Outline (2006–20) and the Made in China 2025 plan include key roles for the state in shaping and supporting private sector accumulation and developing foreign technology.

This underscores the reality that addressing China's trade and investment practices cannot be solved merely by China buying more stuff from the United States. Instead it will require that China returns to a genuine path of economic reform.



Loading ships at the Yangshan Deep Water Port, Shanghai. China 'is using its growing economic weight to alter trade and investment rules in its favour'.

The United States so far has pursued only limited trade action against China in the form of steel and aluminium tariffs pursuant to Section 232 of the Trade Expansion Act of 1962. More serious tariffs are proposed pursuant to the Section 301 report.

US steel and aluminium tariffs, while limited in terms of their impact on China, shed light on the limitations of US strategy. These tariffs are unnecessarily undermining the rules-based trading system and alienating US allies. Consequently, they are exactly the opposite of what is needed to effectively get at the China challenge.

Relying on Section 232 to impose the steel and aluminium tariffs meant that the administration had to develop a national security justification for them. The problem is that such a claim is not particularly credible. Chinese steel imports account for 3.5 per cent of US imports, while almost 70 per

cent of US steel imports are from its allies and FTA partners. As a result, the tariffs' main impact will be on key US allies and partners such as the European Union (EU), Canada, Mexico and South Korea. Trump's willingness to offer exceptions from such tariffs for reasons unrelated to national security—such as the conclusion of the NAFTA renegotiation—further undermine the administration's national security claims against China.

By relying on a broad and seemingly baseless national security exception, the United States has potentially seriously undermined international trade rules. The administration has given a green light to other countries also using (or looking to use) national security reasons to justify trade restrictions—something that China is indeed already doing. Though WTO rules include an exception for national security, governments have so far only sparingly invoked this exception because of the self-defining nature of

what constitutes national security.

The effect of the Section 232 tariffs must be understood in the context of a larger erosion of trust in US trade policy. Trump's threats to pull the United States out of NAFTA and the WTO, and his focus on trade deficits as proof of whether the United States is losing on trade, have undermined the United States' credibility as a leading defender of free trade. The steel and aluminium tariffs are contributing to a view of the United States as willing to sacrifice hard-won trade norms in the pursuit of short-term and sectional economic (and political) gains.

The Section 232 process also revealed the core of Trump's approach to trade issues: using the threat of tariffs to extract concessions from other governments. The threat of steel tariffs on South Korean exports likely helped along the conclusion of the US–South Korea Free Trade Agreement renegotiation. While

seemingly a win, a wider aperture makes clear the costs of this approach: the domestic economic cost of the tariffs and potential retaliation by trading partners, the impact on trade rules by blowing up the national security exception, and the reputational cost to the United States as a leader of trade liberalisation.

In March 2018, the United States Trade Representative completed an investigation under Section 301 of the Trade Act of 1974 into whether Chinese trade practices related to intellectual property, innovation and technology transfer violate trade agreements, or are discriminatory to and a burden on US commerce. The Section 301 report identifies a range of Chinese trade and commercial practices of concern, including forced technology transfer from US companies operating in China. The report also lists a range of Chinese practices aimed at acquiring or stealing US intellectual property, including cyber intrusions into US commercial networks to access confidential business information and an outbound investment strategy aimed at acquiring US technology.

As the Section 301 report makes clear, all these policies and activities are state-directed and strategically orientated towards helping China to achieve its broader economic goals. These goals are outlined in plans such as Made in China 2025, which identifies robotics, electric vehicles and aircraft, and advanced information technology as sectors that China aims to dominate.

Following the release of the Section 301 report, the United States threatened China with tariffs of US\$50 billion, and when China threatened similar retaliation, Trump doubled the proposed tariffs to US\$100 billion.

A meeting in May 2018 of high-level

... the United States needs to use a broad range of economic tools if it wants to succeed in addressing the state-driven elements of China's economic policy that it finds so troubling

Chinese and US economic officials to address US concerns merely produced agreement for China to purchase more US agriculture and energy products and both sides observed the importance of bilateral investment. Despite the absence of any outcome the administration has so far agreed to suspend the application of tariffs on China.

The lack of any progress on addressing the China challenge underscores that fact that the United States needs to use a broad range of economic tools if it wants to succeed in addressing the state-driven elements of China's economic policy that it finds so troubling. In addition to using trade and investment restrictions, the United States needs to build new rules and norms that create costs over time to China for continuing to pursue its economic practices. To be effective, other key economies—such as the EU and Japan—will need to be brought onboard with this strategy. Failure to adopt a coordinated and multi-country approach will likely

doom any US efforts.

There is already some convergence among key allies such as the EU, Japan and Australia on the economic and trade challenges presented by China. But serious engagement with such countries on developing a common approach to China's trade challenges is lacking. Moreover, an outcome that merely leads to China buying more agriculture and energy products from the United States is likely also going to mean less being bought from other key exporters to China, including allies such as Australia and the EU.

The Trump administration needs to rejoin the CPTPP and expand the agreement's membership further. Creating a new set of regional trade rules that discipline uncooperative economic behaviour will be key to creating incentives for China to reform over time. Trump's announcement that the United States would rejoin the CPTPP, only for the step to be reversed shortly thereafter, not only misses this opportunity but also further undermines allies' and partners' trust in and willingness to cooperate with this administration.

The WTO can play a supporting role in building the normative environment for trade action against China. For this to happen, the Trump administration needs to stop undermining the WTO and signal its ongoing support for the rules-based system.

This will require a broader view of the potential role for the WTO in addressing the China challenge. In particular, it will require that the United States itself abides by international trade rules. During its time as the world's only hegemon, the United States by and large supported a rules-based trading system. US compliance with international trade rules conferred legal equality on all

states and created an implicit bargain along the following lines: the United States would abide by the rules and in return other countries would work with (or at least not seek to frustrate) the United States when its core trade interests were at stake.

Threats by Trump to leave the WTO, combined with his claims that trade deals are bad for the United States, call this bargain into question. In so doing the Trump administration is upending how countries assess the value of cooperation with the United States on trade and economic issues. This is also why Chinese President Xi Jinping has been so quick to seek to establish China as the new leader of a rules-based order. It has less to do with whether in fact China is prepared to liberalise than it is about replacing the United States at the centre of this bargain.

There are areas where China's trade actions may be inconsistent with its WTO commitments and where rigorous prosecution of these claims at the WTO should be pursued. To the current US administration's credit, WTO disputes have been initiated, such as a recent claim addressing China's use of licensing to limit how US companies protect their technology. The rub is that China is also using the WTO to challenge US trade actions, including the steel and aluminium tariffs and the legality of the Section 301 process itself.

The advantage of including WTO action as part of the US response is that it reaffirms US commitment to global trade rules and, by highlighting where Chinese trade practices depart from agreed norms, will create political space for countries to support US efforts against China.

China poses a real challenge. The current US approach is too narrowly focussed on tariffs to develop the incentives and opportunities for the type of economic reform that China will need to undertake to truly address the problem. At the same time, the US approach has real costs in terms of the rules-based system, and the credibility and desirability of US leadership more broadly. Failure to develop a more nuanced, comprehensive and coordinated approach to the China challenge risks not only falling short but, in the process, deeply damaging the international economic system that the United States purports to uphold.

EAFO

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Harvesting the golden grain on an Australian farm . A trade deal between the two big trans-Pacific economies that simply leads to China buying more agricultural and energy products from the US is likely to mean less being bought from exporting nations like Australia.



Applause from Chinese leaders at the close of the National People's Congress in Beijing in March 2018—but there are major institutional challenges ahead.

Where is Chinese governance headed?

ZHA DAOJIONG

IN March 2018, China's constitutional amendments made headlines around the world. Among other things, the amendments removed the two-term limit on China's presidency.

Media reaction abroad ranged from seeing the amendment as yet another bit of evidence that China is on a 'great leap backward' to warning against 'always respond[ing] to any political event in China with all the enthusiasm

of a funeral director.' By and large, the mood is one of serious questioning: how did the West get China so wrong in expecting the Chinese political system to liberalise Western-style?

At the other end of the spectrum, voices in media outlets sponsored by a Hong Kong-based entity with close links to the authorities in Beijing bluntly say that 'the West is wrong about China's president' or invite foreign observers to accept the Chinese differences as normal.

One explanation for the pessimism

about Chinese governance is the recent return to polemics reminiscent of the earlier years of political reform. For example, the notion of a 'core leader'—de-emphasised during the Hu Jintao years—implies a reduced emphasis on consultation among different levels of the Chinese Communist Party (CCP) as a mechanism for decision-making.

Another example is the inclusion of a leader's personal name in a political doctrine ('Xi Jinping Thought on Socialism with Chinese Characteristics

for a New Era'), enshrined in the party charter and state constitution. It is only the second time (after Mao Zedong Thought) that this has happened. The 50th anniversary of the formal beginning of the Cultural Revolution came and went in May 2016. Yet apprehension about personality cults remains real.

As is true in most other polities, harmony in conception and implementation of policy frequently relies upon synergy developed by personnel appointed to key offices of the government. The duration of the Xi presidency is for the future to tell. Nonetheless, it is true that the past five years have seen a steady process of appointments at the ministerial level and above going to individuals who have had a close personal working relationship with Xi during his years in the provincial-level government. This raises questions about meritocracy, an attribute that carried China throughout its history, especially in times of uncertainties inside the country and abroad.

Between the glowingly positive rhetoric from officially sanctioned presentations and well-intended scepticism, there are competing assessments of the effectiveness of the leadership teams before Xi took office. Chinese leadership during the decade headed by former president Hu Jintao was generally viewed to be thus far the most collaborative and consultative among top Party leaders.

In some respects, China moved in the right direction during the first decade of the 2000s, especially given the psychological shock that accompanied the outbreak and spread of the global financial crisis in 2008. Millions of Chinese were lifted out of abject poverty. The Beijing Olympics were a success. The bullet train between Beijing and Shanghai was

built. And China surpassed Japan to become the world's second largest economy.

The list of positive indicators could be much longer. Some pundits coined the term 'Beijing Consensus' as a pointed reminder of the supposed bankruptcy of the 'Washington Consensus' that was widely believed to have contributed to world economic growth before the financial crisis.

In other respects, beginning with the ever-worsening air pollution across cities large and small, the soaring costs of housing, the Bo Xilai affair and growing inequality, Chinese society had reasons for serious concern about the future. Towards the end of the decade, there emerged across China a sense that weak and indecisive central leadership had to end.

No one wants to see the rise of another dictator like Mao Zedong who could go off half-cocked with rash schemes like the Great Leap Forward or the Cultural Revolution. The challenge is to create a collective leadership that functions effectively and authoritatively to restrain the

Though perhaps simplistic in the eyes of an outside observer, the idea of a strengthened leadership at the national level to rein in the cadres is not so alien to Chinese society

parochial interest groups within the state, military and Party that over the past decade have been hijacking policy to feather their own nests.

Foreign observers often miss the point that a society's craving for effective and authoritative national leadership can result in complications on the foreign policy front, too. A notable case of the Chinese government's system-wide ineptitude was political dissident Chen Guangcheng's successful escape—engineered by a US human rights network—from his house in Shandong and transfer to the US embassy in Beijing in April 2012.

There could not have been a more humiliating exposé of the failure of China's internal security apparatus. After all, government expenditure allocated for internal security is understood to be equal to or even surpass that for national defence. How on earth were a handful of NGO activists able to evade the network of security officers assigned to keep Chen in his compound?

The Chen case may be an extreme example of Western human rights NGOs teaching the Chinese government a lesson that 'equality and justice have no [sovereign] boundaries'. For the rank and file in the Chinese governing system, it is natural to ponder where, if at all, there can be limits to the name-and-shame campaign by foreign NGOs, with endorsement and even collaboration by foreign embassies.

Literally millions of Chinese citizens have grievances similar to or more heart-wrenching than that of Chen and his family. The Chinese legal system, overwhelmed by the volume of work in handling in-person appeals, took advantage of modern technology by setting up a website to collect complaints from Chinese who petition

in search of redress ranging from compensation for seized land to justice for murdered relatives. Should foreign treatment of Chen become more of a norm, stress on the Chinese system could become system-wide.

Then, at the heart of the matter is improvement in everyday harmony among the average citizens. Corruption and deviation from national-level policy is considered to be a key cause behind the grievances and failure to effectively address them. Though perhaps simplistic in the eyes of an outside observer, the idea of a strengthened leadership at the national level to rein in the cadres is not so alien to Chinese society.

Xi seized political advantage because of sentiments for change. In November 2017, during the Party Congress, he pledged to shift the party's mission from delivering high-speed—but costly—economic growth to meeting the people's demands for a 'better life'.

The new agenda encompasses a broad array of goals including better public services, stronger social welfare, a cleaner environment, eradication

Financial risks have been identified by the government as one of its three 'critical battles'—together with poverty and pollution

of poverty, closing regional gaps in development and greater global influence. The 19th National Party Congress endorsed a revised national manifesto: by 2049, the centenary of the People's Republic, China is to become a 'great modern socialist country' and a 'global leader'. The vision closely tracks the aspirations of China's growing middle class and reflects an understanding of problems the country needs to fix.

To this end, a set of institutional reforms are being implemented by the decisions of the Thirteenth National

People's Congress. The move to improve efficiency and reduce overlap led to a reduction of the number of ministries from 34 to 26, and elimination of seven non-ministerial agencies.

The changes included setting up new departments, such as the Ministry of Emergency Management, tasked to improve response to disasters such as floods, fires and earthquakes by bringing together the response units in different agencies. The State Grains and Reserves Administration will be set up to manage strategic and emergency-aid goods such as grain, cotton and sugar. A Veterans Affairs Ministry will be established to take care of retired soldiers.

The National Health and Family Planning Commission was renamed the National Health Commission—indicative of the pursuit of a 'better life'. China has allowed two-child families since 2016. As the country rapidly ages, with a quarter of its population estimated to be 60 years or older by 2030, more change is needed on this front.

To better manage China's



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Visitors wear face masks against pollution at the temple fair at a celebration at Ditan Park, the Temple of the Earth, in Beijing. The pursuit of a 'better life' in China requires making difficult trade-offs between economic growth and environmental protection.

natural resources and tackle serious environmental problems arising from its rapid economic growth, two new ministries are being set up: the Ministry of Natural Resources and the Ministry of Ecology and Environment (MEE). The bulk of MEE is the pre-existing Ministry for Environmental Protection, but the renaming is meant to focus on ending the 'pollute first and clean up later' dictum that has been an unfortunate hallmark of China's growth trajectory.

Another major institutional change is the merging of the banking and insurance regulators to reduce financial risk. Financial risks have been identified by the government as one of its three 'critical battles'—together with poverty and pollution. Because the Chinese economy today is far more intertwined with the rest of the world economy, mismanagement of China's

finance could trigger a financial crisis on a global scale.

The new line-up of government agencies does seem to lend credibility to Party instructions that the ultimate goal of governance is not just to make China wealthier and stronger but also allow the populace to 'benefit from the fruits of opening up and reform and get a share of the dividends.'

As far as the unavoidable imagery goes, now that China seems to have the Party and the country rise and fall with Xi, what can go wrong? Again, as in other polities, fear of punishment can be one way to drive discipline into complex and competing interests inside and outside of the government. Along with the creation of the National Supervision Commission, which will administer party discipline over all public servants (including non-party members) to ensure they

act in the public interest, the message for loyalty is loud and clear.

Still, it will be essential for Xi to hear challenges and get feedback from the leadership circle when ideas are flawed and policies produce poor results. Absence of disagreements could mean that he becomes more insulated and prone to mistakes.

In addition, the pursuit of a 'better life' in China requires making difficult trade-offs between economic growth and environmental protection, and among social classes and regions with diverse and contradictory interests. Making such decisions requires more debate and consultation, not less. Communicating the logic behind specific policies to the people will be as significant as the policies themselves, and in many cases, more so. To avoid what Mao likened to a 'single spark' that can 'start a prairie

fire,' it will require wisdom, skill and patience in handling the increasing diversity of Chinese society.

In the past few years, China has drawn its foreign policy confidence from its achievements over the past 40 years. This development story embodies what some Chinese mean when they say they will contribute the 'Chinese Solution' and 'Chinese Wisdom' to the world.

Yet as former US president Barack Obama indicated when he set the philosophical basis for the US pivot to Asia, declaring that 'prosperity without freedom is just another form of poverty'. Most of the Western world is far from ready to appreciate development input from China, much less leadership.

China policy is one of the very few issues on which US President Donald Trump does not fundamentally differ from his predecessor in the White House. Both Obama and Trump are demanding that the rest of the world,

in particular governments in the Asia Pacific, think beyond the global chain of production in joining a vision of not losing out to a purported Chinese-led world order. In a way, Chinese rhetoric about a proactive foreign policy orientation reinforces that determination.

Xi observed while hosting Trump in Beijing that 'We have a thousand reasons to get China-US relations right and not one reason to spoil the relationship.' The same can be said of every pair of China's bilateral ties. It is not that such wording is to be challenged. Rather, real differences will exist over who are the 'we', who is doing the 'spoiling' and what is 'right'.

Such differences are not new and, short of truly disastrous mismanagement, it is difficult to envision a systematic breakdown of China's relationship with any of its partners. The prospect of China having a president for life, at least in some quarters, adds fire to the fury

over China apparently having short-changed expectations from the outside world. Yet contemporary history has demonstrated that the Chinese polity can be fast at adapting to trends. It is too early to draw definitive conclusions about the future of China.

China thrived by being open to the rest of the world, and the world is much better off today to have the challenge of competition from China rather than the humanitarian challenge it had forty years ago. Keeping the lines of communication open—in all weather, domestic and diplomatic, and at the levels of both governments and societies—is the bare minimum approach for managing differences and preventing misjudgements. In a geostrategic sense, competition rather than confrontation is by far the preferable future. **EAFO**

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According to President Xi Jinping, there are 'a thousand reasons to get China-US relations right and not one reason to spoil the relationship'. Short of 'truly disastrous mismanagement', it is difficult to see a systematic breakdown of China's relationship with any of its partners.

PICTURE: THOMAS PETER / REUTERS

Ecstatic supporters of Mahathir Mohamad celebrate the defeat of the Barisan Nasional (BN) coalition outside the hotel in Petaling Jaya where the new Prime Minister was holding his victory news conference.



GE14: Malaysia's modernisation tsunami

DAN SLATER

DEMOCRATISATION scholars hate modernisation theory as much as anybody. From a modernisation perspective, so-called 'developing countries' are on some sort of uniform track towards a liberal and democratic future, as if some imagined unity called 'the West' had already laid it down for them.

This notion has long been

discredited and is even considered offensive in most academic circles. As countries like China, Malaysia and Singapore have gotten rich while remaining authoritarian, the contrary perspective only seems to become more obviously correct: that there are multiple pathways to the modern world, many of them illiberal and undemocratic.

The most sophisticated quantitative research consistently confirms the

unbreakable global correlation between national wealth and levels of democracy. Still, scholars of particular countries and regions tend to dismiss the idea that democracy becomes much likelier as a country becomes much richer.

But then something happens like Malaysia's 14th general election (GE14). Malaysia has been getting richer for decades, yet the ruling United Malays National Organisation

(UMNO) and the Barisan Nasional (BN) coalition that it commands have continued to fend off its opponents in undemocratic election after undemocratic election. GE14 was no more democratic than its recent predecessors, with the playing field tragically skewed in the BN's favour.

Nonetheless, an eclectic assemblage of opposition parties led by the People's Justice Party (PKR), which has been leading the charge for democratic reforms since the reformasi movement began in 1998, swept to a decisive victory, seizing 122 national parliamentary seats to BN's 79.

Virtually all dedicated Malaysia-watchers professed themselves shocked by the result. But if leading modernisation theorists like Seymour Martin Lipset or Samuel Huntington were still alive—even in their fusty 1950s and 1960s guises—they wouldn't have been surprised in the slightest.

Naturally economic growth leads to a larger and more educated urban middle class, modernisation theorists have long argued. This middle class will resent the kind of grand corruption that outgoing prime minister and scoundrel-in-chief Najib Razak engaged in alongside his pantomime villain of a spouse, Rosmah—so egregiously in the 1MDB scandal as to reach moustache-twirling levels of cartoonish absurdity. They will be less vulnerable to ethnic and religious appeals or to the kinds of petty blandishments that can win over poorer voters in the countryside. They will want equality, freedom, the rule of law and public goods. Their vote cannot simply be coerced.

Nobody thinks it is impossible to maintain authoritarian domination as a country undergoes decades of rapid socioeconomic change. But as Najib and Rosmah can now tearfully attest,

it gets harder and more expensive. It takes a whole lot of money to buy electoral love in a society with a mushrooming middle class.

GE14 was thus not the 'Malay tsunami' that incoming (and returning) Prime Minister Mahathir Mohamad so irresponsibly called for. Nor was it a 'Chinese tsunami', as Najib dubbed BN's 2013 loss of the popular vote in such an incendiary fashion. It was more like a modernisation tsunami. And, like a real tsunami, modernisation has its most powerful sources at deep levels, where nobody in particular can command it.

Not even as commanding a figure as Mahathir. His adoring fans are bestowing credit upon him for the electoral win in tones smacking of feudalism and hero worship more appropriate to an absolutist sultan than a democratic leader. This echoes the credit they have long given him for Malaysia's economic development.

Yet in both instances Mahathir relied more on luck than on skill. On the development front, he was lucky to inherit a strong and developmentally capable state apparatus that he

The only time UMNO has seen its election performance improve this millennium was in 2004, when voters were freshly rejoicing at Mahathir's overdue resignation in late 2003

sadly chose to use autocratically and brutally with devastating long-term consequences.

As for the election, Mahathir was lucky to hitch a ride on Malaysia's modernisation tsunami just as it was cresting. Visible as he may be, Mahathir is but foam atop this long-swelling opposition wave. The opposition didn't need Mahathir to deny the BN its two-thirds majority in 2008 or to win the popular vote in 2013. The only time UMNO has seen its election performance improve this millennium was in 2004, when voters were freshly rejoicing at Mahathir's overdue resignation in late 2003. And of course he wouldn't have been victoriously surfing the wave of GE14 at all unless rightful opposition leader Anwar Ibrahim were still in prison, where Mahathir so cravenly shunted him in the first place.

Mahathir is not merely an oppositional Johnny-come-lately; he is the biggest obstacle to democratic opposition's development that Malaysia has ever seen. Credit for GE14 should go to the tireless activists and opposition politicians who began braving the iron claws and filed teeth of the Mahathir regime in the late 1990s, and in some cases even the late 1980s. Unlike actual tsunamis, modernisation tsunamis are made over the long haul by men and women—those with the courage to translate socioeconomic transformation into a freer politics for their countrymen and countrywomen. This victory is theirs.

EAFC

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Regional leadership can reinvigorate action on trade

MARI PANGESTU AND
CHRISTOPHER FINDLAY

THE world in which Asia Pacific economies operate is changing. Two main forces are driving this change—one ‘top-down,’ the other ‘bottom-up.’

The top-down force is the emergence of a world with a larger number of key economies. In recent decades, growth rates around the world have diverged. For much of Asia, this has meant dramatic improvements in incomes and a huge reduction in the number of people living in poverty. It has also meant a new order among countries—a multipolar world.

The bottom-up force is the change in the way production is organised, driven by progress in communications and information technology. Technological improvements have shifted the location of production, with production processes becoming increasingly fragmented across countries. The nature of work and the composition of skills within economies have changed.

Given the new order of production and trade, the Trump administration’s mercantilist focus on reducing merchandise trade deficits will end up hurting the United States, as well as disrupting global production networks.

As trade flows change, pressure for domestic structural change can arise. In the United States, a decline in support for international trade and openness has been exacerbated by a lack of adjustment support for



PICTURE: JONATHAN ERNST / REUTERS

Delegates at the US-ASEAN summit in Manila in November 2017 listen to a screened address by US President Donald Trump. ASEAN is well placed to contribute to regional leadership in revitalising trade.

geographically concentrated bearers of the burden. Their reaction via domestic political processes has shocked the international system.

In the United States and elsewhere, good macroeconomic outcomes no longer win elections. Much economic policy is now driven by nationalistic and protectionist politics. This is particularly evident in US initiatives to protect its domestic production and seek adjustments from China.

These political conditions were preceded by waning support for openness at a multilateral level. As multilateral negotiations stalled, the response has been the emergence of ‘mega-regional’ platforms such

as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP or TPP 11) and the East Asian Regional Comprehensive Economic Partnership (RCEP).

These initiatives sit atop a ‘noodle bowl’ of messy bilateral agreements. Before the current US America First regime, these mega-regional and bilateral agreements still operated under the lid of the World Trade Organization. The rules-based trading system was still an anchor for economic integration, especially the dispute settlement mechanism.

Today, the principles of openness, non-discrimination, transparency and

open regionalism—which have helped generate prosperity in the region, especially for developing economies in Asia—are being severely challenged. When the United States leaves the TPP, undertakes unilateral action and declares that the multilateral rules have not served US interests, the anchor of the trading system is challenged. At most international forums like the G20, policymakers' time is being wasted on phrasing defensive communiqués instead of cooperating on the substantive trade and investment issues of the day.

At the same time, new issues are emerging in relation to trade and investment, such as the taxation of international income flows, the treatment of data flows and the management of intellectual property. Responding to climate change and finding appropriate policies to deal with inequality are also among the challenges.

In addressing these issues, the principles of openness and non-discrimination, balanced with transparency on issues of standards, security and privacy, should be the anchor. But progress will be difficult in the multipolar world without clear leadership from the major economies.

Waiting for a consensus to emerge among key economies about the importance of maintaining these anchor principles—while at the same time dealing with the new issues that have emerged—is not an option. There are no obvious forces now at work to resolve this lack of consensus within a reasonable timeframe. Lower-income people in rural ASEAN areas, for example, should not have to wait for the rest of the world to figure out how to shift their own economies and communities to new sources of growth.

In the absence of leadership from

Lower-income people in rural ASEAN areas, for example, should not have to wait for the rest of the world to figure out how to shift their own economies and communities to new sources of growth

the advanced economies, a shared leadership model in the region should be the answer. The key then is the response of the increasingly influential 'second-tier' economies. No actors are more important than Indonesia and Southeast Asia, operating through ASEAN and the ASEAN-plus regional agreements that are already in place and being consolidated under RCEP.

Recent statements by leaders in Indonesia indicate recognition of the role it can play and wants to play. But Indonesia's contribution will be so much greater and more effective if it acts in concert with others. Concerted action could take multiple forms. It might include unilateral reforms, or working on sustainability initiatives that are in both local and global interests.

Effective concerted action depends on a few factors. Foremost, it depends on shared principles. Part of this is agreeing on a purpose, such as the basic principles of non-discrimination, transparency and support for the rules-based trading system. Other principles can relate to specifics, such

as the management of open data flows. These principles provide important reference points as countries take their own actions. There is value in sharing experience and aligning countries' expectations about each other's reform programs.

These are not new approaches. Readers with long memories will recall efforts like the APEC non-binding investment principles and Individual Action Plans. But this is the point—we already have relevant structures for mobilising this cooperation that can be rejuvenated.

APEC is the most relevant example. Putting weight on APEC does incur a risk, since the domestic positions of participating officials will still be on show. But APEC has important features, including a well-developed network of second-track structures which stands ready to be engaged more deeply. Given the complexities of the new issues facing the regional economic order, it is even more imperative that there be wide, multi-stakeholder participation and input.

Even more importantly, APEC remains a forum in our region where key economies in the multipolar world and the leading second-tier countries can interact effectively, and where the major protagonist, the United States, can still be engaged. **EAFQ**

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Prime Minister Shinzo Abe and President Donald Trump: the Japanese leader has centralised trade negotiations in his office.

Japan's globalisation strategy under pressure

FUKUNARI KIMURA

THE negotiation over the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) that concluded in March 2018 was perhaps the first occasion for Japan to take a distinctive initiative in international trade talks. After the United States withdrew from the original Trans-Pacific Partnership Agreement (TPP 12) in January 2017, three conditions enabled Japan to play a more active role.

First, Japanese Prime Minister Shinzo Abe has retained the Prime

Minister's office for a long period by Japanese standards. He has deprived notorious bureaucrats of the opportunity to play a part in shaping policy initiatives and established a designated office for the Trans-Pacific Partnership negotiations directly under the Prime Minister's Office.

In the past, a typical negotiating team for a free trade agreement (FTA) consisted of representatives from the Ministry of Foreign Affairs, the Ministry of Economy, Trade and Industry, the Ministry of Agriculture and the Ministry of Finance. These representatives often fought harshly

among themselves—even in front of their foreign counterparts. Poor coordination among them substantially weakened strategic moves and lessened their negotiating power. Now, Japan's political leadership is overcoming traditional inter-ministry competition. Although the TPP team has already been downsized, the way of working towards FTAs has fundamentally changed.

Second, Japan was well prepared for the CPTPP negotiation. TPP 12 was signed in February 2016 and Japan formally reported the treaty's ratification to the other negotiating

countries in January 2017. By then, the related domestic laws and amendments had been approved by the Diet and most of the necessary domestic legislative changes had been completed. The CPTPP negotiation was deliberately designed so as to keep the original text of TPP 12 intact as much as possible. This was crucial not only to preserve the spirit of TPP 12 but also to save costs in Japanese politics. No additional domestic adjustments were needed for the CPTPP. This was particularly effective in taming the agricultural lobby.

Third, the majority of Japanese support the idea of TPP 12, at least in so far as they understand its elements. They believe that the competitiveness of Japanese firms resides in their active involvement in East Asian production networks. Thus the betterment of the East Asian investment climate is vital. TPP 12 or CPTPP will be a model FTA in East Asia in terms of the level of liberalisation and the advancement of international rule-making. The perception of globalisation in Japan may be a bit different from that in other developed countries, as Japan strongly believes in international production networks.

In parallel with the TPP, Japan has already completed the negotiation over the Japan–EU Economic Partnership Agreement. The diplomatic relationship with China has been restored to some extent and negotiations over the Regional Comprehensive Economic Partnership (RCEP) and the China–Japan–Korea FTA are ready to be accelerated. Japan is trying to be a hub of multiple mega-FTAs and there is public support for this concept.

Counter to Japan's interest in mega-FTAs, the United States wants to launch a bilateral FTA negotiation with Japan. This is motivated by US

President Donald Trump's obsession with removing bilateral trade deficits. Japan is trying to win some time in order to validate the CPTPP and set up an accession negotiating for the United States. Japan hopes to narrow down the negotiation agenda to just 22 suspended items in the CPTPP—though this may or may not work. In any case, Japan must eventually negotiate with the United States over a bilateral FTA, the CPTPP, or both.

WHAT is Japan afraid of? It is that the three conditions that enabled Japan to take the lead in the TPP 12 talks may be somewhat loosened.

First, Abe's strong political stance is being shaken by a number of arguably small scandals. Although the ratification of the CPTPP has now gone through the Diet, opposition parties are not willing to talk about related domestic laws. Political turmoil may be coming.

Second, negotiating with the United States means that Japan has to revisit liberalising agriculture to some extent. TPP12 involved some partial trade liberalisation commitments in agriculture. As a result, the tariff removal ratio—that is, the ratio of the number of commodities for which the tariff will be zero—went up from 84–89 per cent in previous FTAs to 95 per cent in TPP 12.


Yet five major agricultural products—namely, rice, wheat, meat products, dairy products and sugar—still retain various forms of trade protection. The United States will try to put some of these products on the table, regardless of whether the negotiation is over the CPTPP or a bilateral FTA. Japan must be prepared to clean up obvious weaknesses in its negotiating position, but disappointingly does not seem to be

making any serious effort to do so.

Third, support for TPP12 and CPTPP is backed up by the belief in rule-based international commercial policies. But the coming negotiations with the United States are unlikely to be along the same lines.

The renegotiation of the United States–Korea FTA that concluded in March 2018 provides a lesson. Under great pressure from US negotiators who perhaps mentioned steel and aluminium tariffs and national security commitments, South Korea suddenly made a series of concessions that are not consistent with the spirit of the rules-based approach. These included voluntary export restraints on steel, compulsory import quotas for US automobiles with looser safety regulations, and backsliding in liberalisation commitments by the United States.

In particular, the use of politico-economic links in negotiations to get good deals will be very costly for international norms. Dirty concessions by smaller states are the least immediately harmful response to dirty requests by a big power. But such agreements degrade international trust in the rules-based trade regime.

Can Japan resist the temptation to make dirty concessions and keep to its globalisation strategy? To be consistent, Japan should be ready to clean up its agricultural protections. Japan should also understand that further trade liberalisation in agriculture and bad deals in automobiles are not equivalent. One way or the other, the negotiations with the United States will start soon. 

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Rewriting the rules may tear world trade apart

PICTURE: LEAH MILLS / REUTERS

PETER ROBERTSON

PRESIDENT Donald Trump's threats of trade wars, his politicking with the Trans-Pacific Partnership and his offering special deals for special friends are putting pressure on the world trading system. But they are also just the latest developments in what has been a long downward slide in the institutions supporting international economic policy over the past 20 years. Will Trump be the nail in their coffin, and if so, what will this change achieve for the United States?

Despite the efforts of the World Trade Organization (WTO), the post-war era has seen world leaders indulge in a raft of protectionist schemes, ranging from support for nascent industries to strategic trade policies designed to improve export prices. Examples include voluntary export restraints, anti-dumping regulations and countervailing duties that place uncertainty on exporters and, in practice, provide ad hoc protection for favoured sectors. The protectionist landscape also includes subsidies to agriculture that force down world prices—a practice that makes progress difficult for developing countries. The system is also plagued by technical regulations that are so detailed that they require armies of lawyers to negotiate.

When we add to this list the collapse of the WTO multilateral negotiations through Doha and the rise of regional trade agreements with rules of origin that result in growing



A confidential exchange at the White House between US Trade Representative Robert Lighthizer and presidential economic advisor Peter Navarro before the announcement of new tariffs on steel and aluminum imports in March 2018. Talk of trade wars undermines confidence in the US economy.

complexity, it is clear that the world trading system had a number of problems even before Trump.

This was not how it was supposed to be. The WTO was designed to provide business with stability and a buffer against rival lobby groups and political populism, and to restrain nations from using trade policy as a diplomatic weapon. By the 1990s, after the WTO's initial success, it was

predicted that globalisation would see off economic nationalism.

But as political sentiments have shifted towards nationalism, the WTO and the liberal economic order have been increasingly under challenge. Now Trump is using economic policy as a lever for international relations in ways that the WTO was designed to prevent.

This does not mean Trump is

right to rewrite the rules. Even if the political mood has become more nationalistic, and even if there are political reasons to discriminate in trade relations, the basic premise under which Trump is operating is built on fallacy.

Trump's language makes the fallacy clear. He believes that imports are bad, that exports are good and that import taxes are an effective way to punish foreign partners. Thus, according to Trump, if the United States exports more than it imports, it is 'winning.'

If one accepts Trump's logic, then the next step is to impose import barriers on political rivals and to use threats of import restrictions to help other countries (especially security alliance partners) see things your way politically.

The problem is that import taxes hurt domestic consumers and businesses because whether they purchase imports or local substitutes, they have to pay the higher price. For example, Australia is the world's biggest exporter of iron ore but consumes very little. The ore is primarily mined for its value through export earnings. But producing more iron ore only makes Australians better off if they can use the export revenue to purchase imports. If Australia taxes its imports, then it has to dig up more iron ore to cover the higher cost of those imports. By taxing imports, Australia imposes costs on itself. In the case of the United States it is no different. Trump's import taxes make US consumers and businesses, who rely on imports, worse off.

Ironically the winner from import taxes is government, which gets to keep the tax revenues at the expense of consumers and business. So new import taxes won't be exactly 'draining the swamp' since Washington will collect the tax revenues.

Trump's focus on the trade surplus is equally wrong-headed. The United States' growing deficit is not a symptom of weakness but is, instead, a symptom of strong US demand and emerging economic growth—consumers are buying lots of imports. It also reflects the strong US dollar—the United States is in the enviable position where it does not have to dig up coal or produce cars to pay for its imports, since it can just print dollars that other countries, and particularly China, want to facilitate international transactions and hold as reserves for a rainy day. The purchase of goods in exchange for US dollars creates a trade deficit for the United States, because everyone wants to hold US dollars, not spend them. When an economy is in trouble it's the other way around—any takers for Belarusian rubles or the

The more Trump whips up a frenzy, the more he risks inducing market jitters and a stock market collapse that would have real effects on the economy by reducing the value of holdings of wealth, including the dividends on pension funds

Venezuelan bolivar?

Trump's approach has other problems. Mere talk of trade wars risks undermining confidence in the US economy—an economy that is only now recovering from the global financial crisis. The more Trump whips up a frenzy, the more he risks inducing market jitters and a stock market collapse that would have real effects on the economy by reducing the value of holdings of wealth, including the dividends on pension funds.

Likewise, the bigger the frenzy, the more likely Trump is to generate a bigger trade deficit as consumers and business buy up now in advance of the expected trade war. If firms and consumers believe that Trump will introduce import tax hikes in the near future, they will respond by spending more on imports now.

But perhaps most critically, Trump's 'rewrite-the-rules approach' is further eroding the institutions that were designed to facilitate growth and prevent trade wars. He is opening the door for overt nationalist protectionism as an acceptable way to conduct international relations. This damages the credibility of the United States, and it may take many future generations of presidents to undo this and rebuild trust. It also gives licence to others to act in the same way. Meanwhile China has seized the moment, using the opportunity to pose as the protector of the international order. Trump's approach is a fatal own-goal in his supposed plan to restore the US economy and US global leadership. The system was already under assault, and Trump's attack on it may be fatal. [EAFQ](#)

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Workers inspecting pipes at a steel mill of Hebei Huayang Steel Pipe company in Cangzhou. Imposing tariffs could rebound on the US.

Rebuilding the US consensus on trade

TAMI OVERBY

THE United States is experiencing an existential crisis regarding trade. The 2016 US presidential election highlighted the collapse of the US consensus on trade, with both Bernie Sanders and Donald Trump railing against the Trans-Pacific Partnership (TPP) and free trade agreements. These politicians tapped into the deep-seated fears of American voters that the United States had fallen behind, that outsourcing was hollowing out the United States, and

that free trade deals and China were to blame.

It is ironic that this is happening now—at a time when the United States' unemployment is low and falling (3.9 per cent) and the economy is growing. In spite of rhetoric to the contrary, US manufacturing's contribution to the economy has increased substantially, from US\$63 million in 1947 to more than US\$2 trillion in 2015. Despite competition from Mexico and China, US manufacturing output has doubled over the past 30 years.

So what explains the public disconnect from the facts? One reason is that the benefits of the United States' economic growth are not shared equally. A Pew survey in March 2016 showed that the fear of job losses through the TPP and other free trade agreements was responsible for the political polarisation around trade. The survey identified that most Democrats supported trade agreements, while most Republicans opposed them. The partisan divide also paralleled racial, gendered and age divides. White men older than 65 were the fiercest

opponents of free trade, while Latinos, African Americans, women and younger people were most likely to be supporters.

The strong opposition at a time of historic economic growth and low unemployment indicates that these views are based more on perceived fears rather than facts. Many of the concerns voiced by opponents of free trade included accusations that these deals would force nations to dismantle environmental and labour regulations while enriching global corporations at the expense of workers. There were also complaints of secret negotiations and gripes about the Investor State Dispute Settlement (ISDS) mechanism that allows foreign companies to sue member governments.

The TPP text actually protects health, environmental and labour regulations. Members would be required to recognise unions, establish minimum wages, prevent child labour and promote workplace safety. The TPP negotiations established the highest level of stakeholder consultation in trade negotiations and provided all stakeholders with opportunities to engage. The United States already has ISDS in 51 trade agreements, including NAFTA. Of the 17 ISDS suits brought through the NAFTA ISDS, the United States has lost none.

So what is the answer to rebuilding the United States' consensus on trade? First, it requires a clear-eyed commitment to verifiable facts and a dedicated responsibility to call out erroneous but politically popular misconceptions or misstatements of fact. This responsibility must be undertaken because trade makes the United States safer, not just richer.

At a time when China's ascension as a great power is undeniable, US policymakers, politicians, business

The United States appears to be on the dangerous path of repeating history, with Trump threatening heavy tariffs on China and Beijing threatening to respond in kind

leaders and others of influence must remember the lessons of the 1930s, when much of the world sought protectionism. The Republican-controlled Congress passed the Great Tariff Act of 1930, which raised tariffs to the highest level in 100 years in an effort to protect US jobs and farms from foreign competition. The United States' trade partners followed suit and instituted their own tariffs. The result was disastrous: US imports and exports dropped by almost two-thirds.

In 1932 the Democrats swept into power and provided a different approach in the Reciprocal Trade Agreement Act of 1934. Under this Act, Congress ceded its authority to determine tariffs to the President. In this case, the result was a dramatic drop in tariffs.

The United States appears to be on the dangerous path of repeating history, with Trump threatening heavy tariffs on China and Beijing threatening to respond in kind. Many trade experts and economists fear that this could be the beginning of a global trade war.

Trade wars can escalate into

real wars and economic security is central to national security. A French economist in the 1800s is rumoured to have coined the phrase 'the more trade crosses borders, the less likely troops will'.

Fortunately, people are beginning to take notice. More than 1000 economists are reported to have warned Trump that his trade views echo those 1930s errors. These experts told Trump that his 'economic protectionism' and tough trade rhetoric threatened to repeat the United States' mistakes of the 1930s—mistakes that plunged the United States and the world into the Great Depression.

The clock is winding down towards the US administration's deadline to complete the NAFTA negotiations while still being covered under the current Trade Promotion Authority that expires on 1 July. We will see whether the President truly understands this context or instead prefers to continue with his brand of threats and bullying tactics that risk upending longstanding relationships and major US supply chains.

At the same time, the US administration remains hyper-focused on the US\$375 billion merchandise trade deficit with China. Both governments have indicated a desire to avoid a trade war. There have been high-level delegations to negotiate exactly how much the Chinese are willing to accept to avoid punitive action, but whether this is enough to satisfy the Trump administration remains to be seen. What is very clear is that more trade turbulence is to be expected. **EAFO**

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A piper leads protesters demanding a vote on the Brexit deal between Britain and the European Union through the streets of Edinburgh.

No easy choices as Britain launches a new trade regime

PAUL GRETTON, DAVID VINES AND ANNIE WILLIAMSON

THE outcome of the Brexit referendum has imparted a drastic shock to the UK economy. The United Kingdom must choose between three options as it seeks to refashion its international trade relationships.

The first option is for it to seek to avoid a protectionist outcome by reversing its decision and remaining in the European Customs Union and European Single Market.

Under a second option, it can

withdraw into a more protectionist environment, in which it leaves the Customs Union and Single Market but forms market access agreements and free trade areas (FTAs) with other countries. This second option is the preferred UK government policy at present.

The third option would be for the United Kingdom to leave the Customs Union and Single Market, and reduce its tariffs and liberalise its own borders, in an attempt to open up its trade with the rest of the world.

The economic costs to the United

Kingdom of withdrawing from the Single Market and the Customs Union will be large. The European Union (EU) accounts for half of Britain's exports. It is true that EU tariffs are (for the most part) very small, apart from textiles and clothing, heavy industry (including motor vehicles) and agriculture. But losses will still accrue to the United Kingdom, if the United Kingdom and the rest of the EU both close their markets to each other's goods and services. In particular, the costs of leaving the EU will extend beyond being subject to

tariffs—the United Kingdom will lose access to the EU’s financial market openness and the EU’s regulatory architecture in many industries such as pharmaceuticals and air transport.

If the UK does not reverse its decision to exit, which of the other two approaches would be least costly?

The preferred UK government policy at present is to negotiate FTAs with other countries and to negotiate a new agreement with Europe (the second option). But the gain from these actions is likely to be extremely small for two reasons. First, negotiating bilateral agreements is time-consuming and the costs of doing so are high. Second, the agreements—even any new agreement with the EU—will inevitably include productivity-sapping regulations that are designed to enforce preferential rules of origin. Partly because of this, the take-up of negotiated market-access preferences will only be partial.

Furthermore, the EU already has free trade agreements with countries that make up another 17 per cent of the United Kingdom’s export market—such as South Korea, Canada, Singapore, and the countries within European Free Trade Association—and is at present seeking additional agreements with other countries. Thus the United Kingdom’s planned negotiations of new agreements with other countries may do no more than maintain the status quo, rather than leading to new opportunities.

With the United Kingdom contributing only about 3 per cent of gross world product, it is unclear how powerful the United Kingdom would be in any FTA negotiations. Negotiating partners are unlikely to want to take the United Kingdom as a standard-setter. A hub-and-spoke system with the United Kingdom at its centre is extremely unlikely.

Might unilateral liberalisation (option three) combined with domestic reform efforts be an alternative way of mitigating the negative effects of Brexit? Under this policy, the United Kingdom would open its borders to Europe and elsewhere. It would seek to increase its trade with the most rapidly growing parts of the world, particularly the Asia Pacific region. At the same time the United Kingdom would foster productivity improvements at home.

Since overall tariff levels are low, unilateral liberalisation would not make much of a contribution to offsetting the trade costs of exiting from the EU. Unless combined with substantial domestic productivity-improving domestic reforms—which would be difficult to achieve—any liberalising moves by the United Kingdom would not greatly offset the wider costs of exiting the EU Single Market.

Further, efforts to liberalise the UK economy would need to be gradual in industries that are highly dependent on government assistance, and which will lose access to the European market. This is particularly the case for some agricultural and manufacturing

With the United Kingdom contributing only about 3 per cent of gross world product, it is unclear how powerful the United Kingdom would be in any FTA negotiations

activities, including in the textiles and clothing industry and in the heavy manufacturing sector, including motor vehicles. In short, the domestic gains from option three are likely to be small.


Seeking greater economic integration in the Asia Pacific may also prove to be harder than it seems. Any difficulties faced by the United Kingdom in accessing the economic opportunities available in this region would not be helped by new regional mega-agreements, such as the Regional Comprehensive Economic Partnership and the revamped Trans-Pacific Partnership (the TPP 11), which are much closer to preferential agreements. They would also not be helped by perceptions of globalisation in some countries in the region—in particular China—that are cast mainly in terms of access to foreign markets rather than the opening up of domestic markets.

The Irish border issue is also critical. If the United Kingdom carries out the government’s preferred option (the second) a hard border will need to be established between Northern Ireland and the Republic of Ireland, potentially endangering the Good Friday peace agreement of 1998. A hardening of the border will also be needed to be established if option 3 is pursued. In December 2017 the UK government announced that it would maintain an open border between Northern Ireland and the Republic of Ireland. It is hard to see how this will be done without the United Kingdom remaining a member not just of the European Customs Union but also the Single European Market, potentially forcing the United Kingdom back to option one.

Even if the British government does get round the Irish hurdle, it will be important for the United Kingdom to

Social, not trade protection promotes prosperity

avoid an elementary mistake. That is, it would be odd if the United Kingdom sets aside membership of the Customs Union and Single Market in order to pursue partial liberalisation of trade with only a small number of other trading partners outside Europe. The unilateral opening up of the United Kingdom's trade with the rest of the world is unlikely to be a way of squaring this circle.

In recognition of the nature and scale of the choices facing the United Kingdom, there is a need for a national policy review institution in which proposed reforms to the United Kingdom's trade and domestic policy can be assessed according to their potential impact on the national interest. At present, the United Kingdom does not have a forum in which these issues can be clearly discussed. 

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Many of the issues raised in this article were discussed at a meeting on Brexit and the United Kingdom's trade choices, convened by the Centre for Economic Policy Research and held at the National Institute of Economic and Social Research in London on 7 February 2018. A report of these discussions can be found at (<https://cepr.org/2507>).

JENNY GORDON

POPULIST support for tariffs and other barriers to trade stems from the misconception that protecting industries from import competition will bring back well-paid manufacturing jobs, and prosperity with it. This conception is wrong at many levels.

First, trade protection does not protect employment—it reduces the size of the economy and the economy's ability to support well-paid jobs. Second, while income growth is not shared equally, gains to trade have supported more generous social welfare systems and contributed to a massive decline in global poverty. Third, trade protection does not help those at the bottom of the income distribution ladder, nor does it reduce job insecurity.

Social protection, from income support to publicly funded education and health services, works to offer the same opportunities to all future and current workers. These social services build the resource base needed for a thriving economy, ensuring a supply of healthy, educated workers. Social protection secures the social compact between governments (and business) and the people. Inclusive economic growth supports openness, and openness is key to economic prosperity.

Globalisation, brought about by

falling barriers to trade and costs of transportation, changes the economic structure of economies as resources shift into activities where an economy has comparative advantage. Selling the things that one produces at a lower resource cost and buying the things that other countries produce at a lower cost is a win-win for all involved. The high correlation between growth in global trade and global income is testament to these gains to trade. But within a country, trade affects different industries and hence their workers in different ways.

The effects are not as simple as production and jobs moving offshore. Open markets increase competition, which spurs investment in new technologies. For example, in periods of major tariff reductions (between 1994–95 and 2001–02), Australian manufacturing output grew at an average annual rate of 2.4 per cent. This growth was achieved with very little change in employment, reflecting a shift to the adoption of new technology and more efficient use of labour.

The continued decline in employment in manufacturing jobs is increasingly due to changes in tastes and technology rather than trade. Developments in robotics and artificial intelligence are accelerating the rise in capital intensity in manufacturing, which means that increasing protection will not bring



A labourer has his dinner under his shed at a construction site of a residential complex in Hefei, Anhui Province. Economic progress 'has and can provide the resources to deliver social programs that ensure that growth is inclusive'.

back well-paid manufacturing jobs for low-skilled workers. Rather, protection would condemn the population to outdated products at higher prices.

Protection also saves some jobs at a cost to many others. For example, recent modelling showed that a rise in US tariffs that led to global contagion would reduce Australia's GDP by around 1 per cent every year and eliminate 100,000 jobs, making the median household worse off by around AU\$1500 a year.

There is an additional cost of protection that is rarely captured in such models. Protection benefits existing firms and workers, reducing their incentives to innovate and to seek new markets. It rewards

lobbying efforts, which detract from productivity because lobbying activities add costs without any increase in production. These incentive effects also undermine the sources of productivity growth needed to create the well-paying jobs of the future. Protection is about keeping things as they are, looking after workers lucky enough to have well-paid manufacturing jobs and the (often foreign) shareholders who own the capital. But change, through technical progress, shifting preferences and changing comparative advantage across and within countries, is inevitable.

All economic progress has winners and losers but, in theory at least,

the winners can compensate the losers and all parties still be better off. In economies with healthy per capita income growth and where the macroeconomic policies are delivering full employment, most displaced workers will be able to find new jobs. Even if their relative wages are lower, overall real wage growth will give them higher purchasing power. This sharing of the gains to trade (from specialisation and competitive dynamics) has formed the core of the social compact between workers, business and governments in support of open markets. But over the past few decades, the share of households in the 'middle class' has tended to decline, particularly in the United States.

Some have blamed ‘unfair’ global competition for the ‘hollowing out’ of middle-skilled jobs in developed countries.

In recent years, stagnant wages for workers below median income in the United States and moribund real wages growth in Australia reflect changing comparative advantages for different types of workers internally as well as externally. Shifts in preferences for services and technical progress have been the dominant drivers, at least since the global financial crisis.

The adage ‘a rising tide lifts all boats’ has often been applied to defend the importance of economic growth, whether delivered by trade or technology. But where the rising tide lifts only some boats, and where it lifts some much more than others, people are more likely to want to hold back the tide. Where the gap is widening and a growing share of people feel their jobs are insecure, as has been the case over the last few decades, there

can be discontent even if everyone has benefited from growth. Discontent is greater when it is clear that some groups in society have been left behind by the changes driven by globalisation, technical progress and changing preferences.

Economists have not paid sufficient attention to the workers whose jobs disappear. They have assumed that they have the skills to shift to other jobs. Neither have they focused on the dynamic impacts of market economics and social trends that leave a growing share of the population at the tail-end of the distribution of skills. ‘Labour’ is not an amorphous bundle of workers who can be put to any task: the inevitable cost of economic progress is that some people will be worse off. Social protection—including income transfers, but more importantly ensuring that healthcare, aged care, education and transport services (roads as well as public transport) are affordable to all—is the best way to

offset this cost.

Government-funded social programs redistribute the gains from trade and technical progress. For example, Australia’s highly targeted income support system is complemented with in-kind provisions that raise household income, particularly for families and the elderly, reducing household inequality (as measured by the Gini coefficient) by almost 40 per cent relative to market income in 2009–10. Even in the United States, social programs have played a major role in reducing inequality. Real household income for the bottom quintile grew by 26 per cent between 1979 and 2014 before taxes and transfers, but by 69 per cent after taxes and transfers. These numbers show the importance of social programs in sharing the gains of economic growth.

Not everyone wins from more open trade, but a strong, well-designed system of social protection can help displaced workers to adjust and also protect the vulnerable. Economic progress has and can provide the resources to deliver social programs that ensure that growth is inclusive. This is essential not only to grow the human resources needed for long-term sustainable income growth, but to deliver on the social compact that underpins acceptance of open markets. Increasing protection only locks in existing inequalities, while reducing the scope to fund social programs. Social protection, rather than trade protection, is the solution that deserves support. **EAFO**

Jenny Gordon has recently retired from Australia’s Productivity Commission, where she was the Principal Advisor Research. She is a Research Associate with the Asian Bureau of Economic Research at The Australian National University.

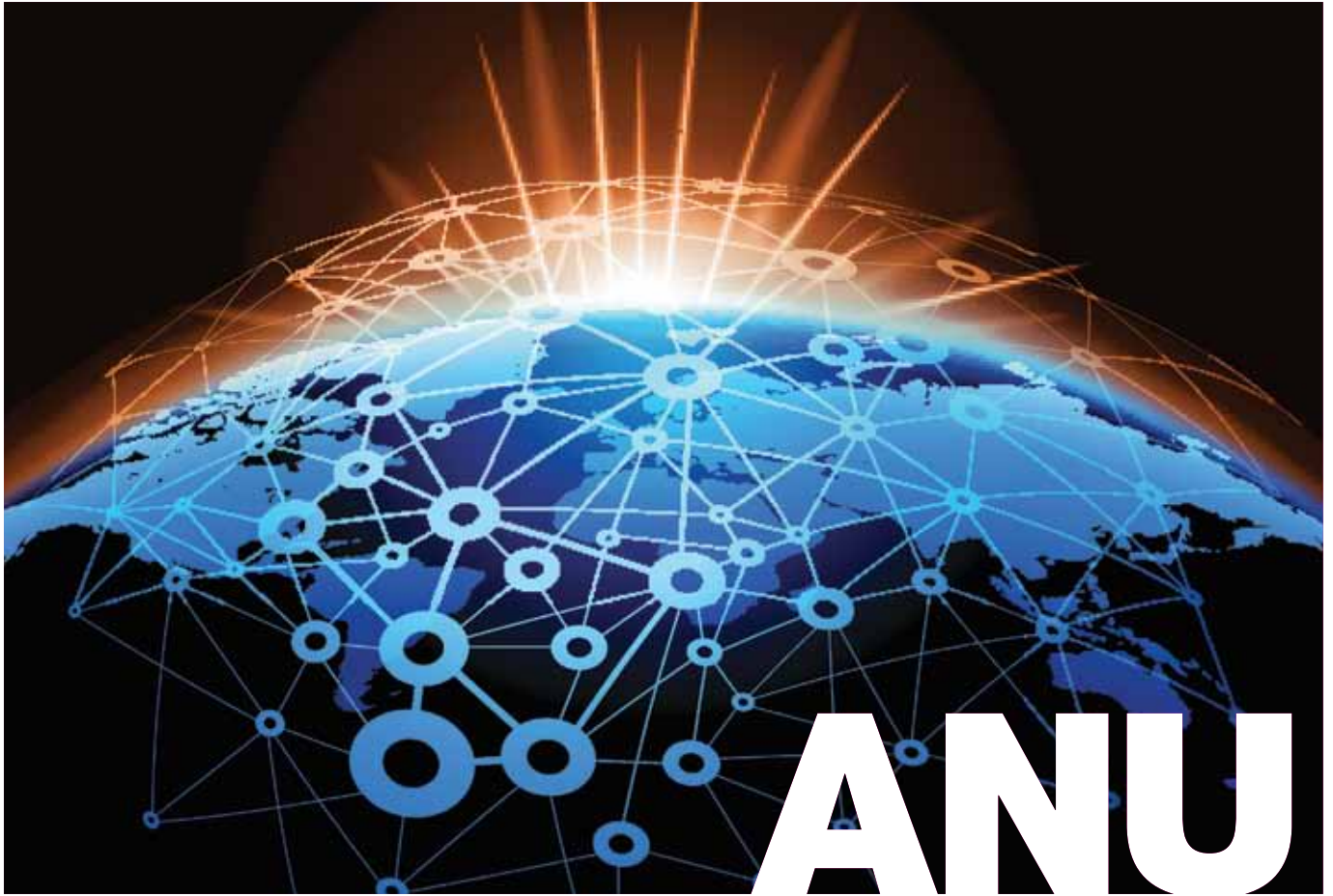


Muslim students in class at Siwilai Pittaya school in Ban Huay Hin Fon village, Chiang Rai, Thailand. Social protection, ‘ensuring that healthcare, aged care, education and transport services are affordable to all, is the best way to offset the cost of economic progress’.

PICTURE: PANU WONGCHA-UM / REUTERS



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