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INTELLECTUAL AMMUNITION

Trade in the Balance

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Why trade is good, why protectionism is bad, and why countervailing duties on Chinese paper are only a small step in the wrong direction.

Update to strategic view

US MACRO: The decision to impose countervailing duties on paper from China is a step toward protectionism, but it is part of a larger policy game aimed at preserving and marginally expanding trade liberalization. Protectionism is a serious risk, but we don't see this as a catalyst for a widespread attack on trade.

[see Investment Strategy Dashboard]

Stocks fell last Friday on the news that the Commerce Department will impose "countervailing duties" on coated paper imported from China. For all the talk in the media from the likes of Lou Dobbs, and in Washington from the likes of Chuck Schumer and Lindsay Graham, stocks understand that trade is good and that barriers to trade are bad. Now almost a week since Friday's announcement stocks have moved higher, reflecting the interpretation -- which we agree with -- that the new tariffs do not signify the Bush administration's first step down the slippery slope of protectionism, but rather they are a small sacrifice to protectionist elements in the new Democratic-controlled congress to head off worse developments. Besides, this is hardly the Bush administration's first step: we've already seen tariffs on steel and wood, quotas on Chinese textiles and clothing, and pressure on the Chinese government to revalue the yuan. Those weren't good developments either, but the world didn't end because of them.

The tariffs on steel and wood were unprincipled sops to particular GOP constituencies, but the actions against China, including Friday's, have all been in the nature of least-bad compromises. For example, the administration's pressure on China concerning the yuan began in April 2005, when it looked like the Schumer-Graham tariff bill -- which would have imposed a 27.5% across-the-board tariff on Chinese goods -- would be enacted, even by a Republican congress. At the very bottom of a scary stock market correction at the height of worries about the legislation, we advocated buying beaten-down stocks, and predicted that the legislation would be withdrawn without a vote, followed days later by a token revaluation (see Tsunamis! Killer Asteroids! Protectionism! April 21, 2005). That's exactly what happened, and stocks went on to new highs (see Policy Takes A Right Turn July 5, 2005 and On the Yuan Revaluation July 21, 2005). For China, revaluing a currency that had been successfully pegged to the dollar, is damaging to growth -- which means it's damaging to trade with the US, which means it's damaging to US growth, too. But the effects are small in the grand scheme of things, and far better than an indiscriminate 27.5% tariff. A least-bad compromise.

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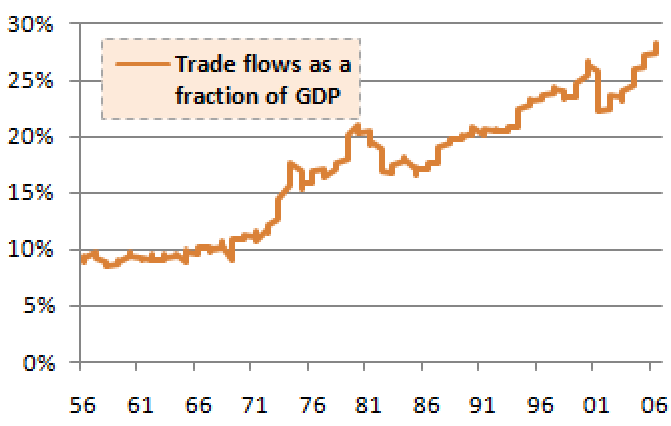
In the case of the new countervailing duties on Chinese paper, there is plausible evidence that it is part of a least-bad compromise. The day before the duties were announced, Senators Schumer and Graham announced that they would be permanently shelving their draconian tariff bill, and eventually replacing it with a milder and more collaborative approach to dealing with China's currency problem. If the countervailing duties were part of a deal to get Schumer and Graham to stand down, then the world is now a better place. But at the same time, the imposition of countervailing duties represents a dangerous new paradigm in US trade relations with China. Its legal basis is the judgment that China is now a "market economy," and thus subject to countervailing duties if it is found to be subsidizing its export industries. With that paradigm now in place, there is a template for other American companies seeking trade advantage to demand similar countervailing duties. So Pandora's Box is open, but only a crack -- it will still be a matter of one-off political judgment as to whether any particular claimant gets the countervailing duties he wishes.

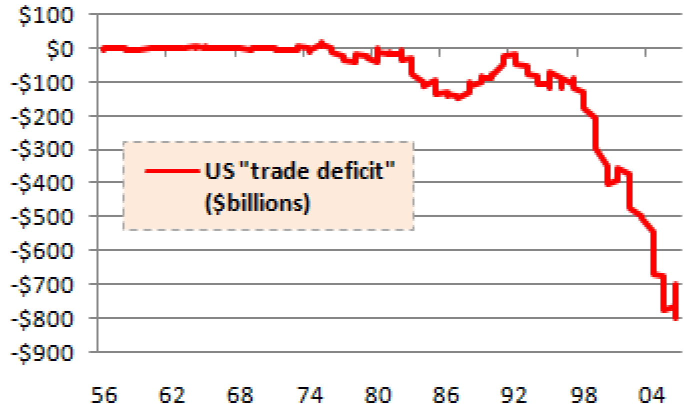
This is part of a larger trend, in which the risk to growth arising from protectionism has gone up with the election of the new Democratic-controlled congress (see [Don't Panic](#) November 8, 2006). From personal conversations with some of the politicians most directly involved, we can report that most of them understand, privately, that trade promotes overall growth, and that none of them wants to kill the goose that lays the golden eggs. But it's a reality after the November 2007 election that organized labor is now the single most influential minority voting bloc, replacing in that role the "religious right" that dominated the GOP-controlled congress. Growth or no growth, the labor lobby wants the implicit subsidy of trade protection. In the case of Friday's paper tariffs, the administration was able to do more than placate politicians in thrall to labor -- NewPage, the domestic paper company that sought the countervailing duties from the Commerce Department, is owned by Cerberus, a private equity firm whose CEO is former Treasury secretary John Snow. Regardless of who, exactly, gets subsidized, politicians now have little choice but to try to pluck as many feathers from the goose as possible, without killing it.



AS TRADE FLOWS, THE ECONOMY GROWS

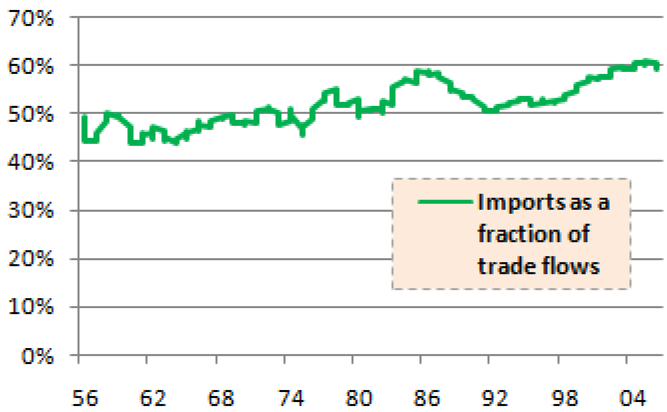
Trade is good -- no, *it's essential* -- because it is the fundamental process of economic interaction, linking producers to consumers. Under *free* trade, goods and services move from those most efficient at producing them to those most efficient at consuming them, allowing production and consumption to both attain their highest values. The wider the scope of trade, the better. If trading with your neighbor is good, if trading between people in different cities is good, if trading between people in different states is good, then trading between people in different countries is good. The wider the scope of trade, the greater the opportunity for discovering optimal combinations of producers and consumers, diversifying counterparty risk, achieving economies of scale, and fostering the competition that leads to innovation and productivity. Almost all economists have agreed upon these ideas for more than 200 years, from Smith and Ricardo onward. In the term used in the global warming debate, the virtues of trade are a matter of "settled science."

Trade between people in different countries has no special economic character versus domestic trade. The only distinctions between domestic trade and international trade are political distinctions. Yet protectionist measures are often justified by appeals to notions of "deficits," "surpluses" and "imbalances" between countries that would never be applied to otherwise identical domestic trade, even in the minds of serious economists who sincerely have no political axes to grind. In the often-heard view, America's "trade deficit" with the rest of the world is dangerous and unsustainable. In our view, it is simply meaningless. In the politicized version of the same concerns, the "trade deficit" represents a dangerous dependency on debt in the hands of foreign creditors. In our view, there is no debt involved whatsoever.



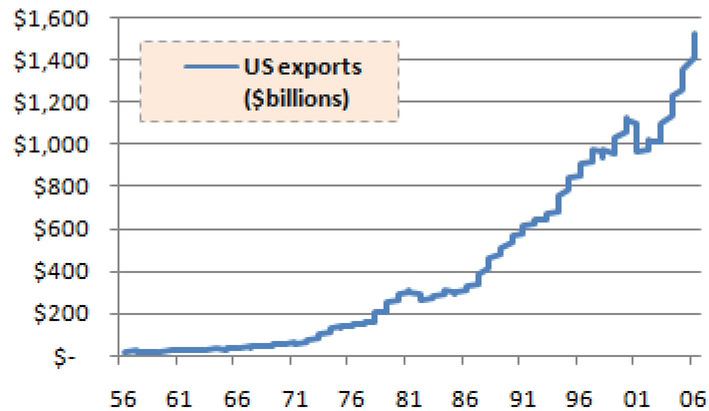
A REALLY BIG NUMBER -- BUT MEANINGLESS

The record-setting "trade deficit" figures so often reported are large. But the record-setting economy is large, too, and trade as a fraction of the economy has been steadily growing for three decades. Failure to see this context of growth leads to the mischaracterization of America as a nation of indebted consumers of foreign goods, who themselves produce little. In fact, the ratio of exports (what we produce in trade) to overall trade flows (exports plus imports) has stayed roughly constant for the last half-century, and today's record-setting level is little more than a tie with the levels seen 20 years ago. What makes this long-term balance work is that, as imports have risen to record levels, so have exports. All the media attention is paid to the imports we consume -- never mentioned is the record $1.5 trillion in exports that America produced last year. For a nation of mere consumers, that's a lot of production.



A MORE BALANCED VIEW OF TRADE

More fundamentally, all trade between nations -- as between individuals -- is always "balanced," in that one must pay for what one gets. When one doesn't pay with offsetting goods and services, one pays with money. A nation such as the United States has sufficient capacity to generate money internally and use that money to buy goods and services from other nations, whether or not those other nations ever choose to spend the money. Until they do, those other nations usually invest it in dollar-denominated securities. When they finally do



NO ONE EVER MENTIONS THE EXPORT BOOM!

spend it, the money is paid to domestic producers for goods and services. And the money will stay invested, because it will simply move into the hands of domestic producers who, themselves, will have to invest it. Where in any of this has any debt been created in virtue of an the simple exchange of money for goods and services, as opposed to the exchange of goods and services for other goods and services -- as though the ideal "balanced" global economy were one that operated on a primitive barter system? Where in any of this is anything "unsustainable," as the critics so often say? There is no theoretical reason why a wealthy, productive country can't indefinitely pay only money for foreign goods; and if ever foreign holders of that money decide to spend it, the only result would be a surge of demand for goods and services in the home country.

If the ever-growing commitment of the economy to foreign trade were bad for American workers, we would surely not be seeing a low 4.5% unemployment rate even as the economy has been coming through a painful "housing adjustment." And if the large "trade deficit" represented the accumulation of "unsustainable" debt, surely we would not be seeing interest rates as low as they are. Thus nothing is "broke," yet protectionist legislation purports to "fix it." Such legislation would only reduce trade, as barriers are erected that prevent the execution of optimal market transactions. As economic actors were forced to settle for suboptimal transactions, they would transact less. Global growth would slow. Reduce trade enough, and growth would contract -- as it did in the 1930s after passage of the Smoot Hawley Tariff Act, following an era of prosperity in which international trade had become almost as important as it is today.

BOTTOM LINE: As global trade has become a larger and larger portion of the economy, the economy has become increasing subject to growth risk arising from protectionism. It didn't matter very much in 1956 when trade flows were only 10% of GDP. It matters a lot now that trade flows are almost 30%. The election of a Democratic-controlled congress intensifies the risk, and Friday's decision to impose countervailing duties on Chinese paper is a small step in the wrong direction. But trade has become such a large part of the economy that it now has its own political constituency, capable of checking the worst protectionist impulses coming from organized labor. So while we don't expect any important new trade liberalization initiatives to succeed, neither do we expect a convulsive lurch to protectionism across the board.