Obama can help free trade with tariffs

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Is Barack Obama really a free-trader? According to much recent commentary, we will find out on September 17, when the US president has to decide whether or not to accept the recommendation of the independent, bipartisan US International Trade Commission to impose tariffs on imports of Chinese tyres.

The orthodox free-trade view of most pundits holds that if Mr Obama accepts the recommendation he will fail the free-trade test. In fact, the truth is just the opposite. Not to accept the tariff recommendation would be a severe blow to open trade and globalisation as well as to America's future economic health.

The conventional view is based on the notion that free trade is always a win-win proposition and that our trade with China fits the conditions of the traditional free-trade model. These include the assumptions that the markets are perfectly competitive, that exchange rates are not manipulated, that there are no economies of scale, that there is no cross-border investment or cross-border transfers of technology, and that there are no government subsidies or export requirements. If this were a true picture of our trade in tyres with China, then imposing tariffs would truly be harmfully protectionist and not be justified.

But this is not even close to the reality of our trade with China, which far from embracing orthodox free trade has openly adopted a neo-mercantilist, export-led economic growth strategy. China keeps its renminbi undervalued against the dollar in order indirectly to subsidise its exports. Foreign direct investment in China is often induced by the use of special, targeted tax and financial incentives. Foreign companies investing in China are often required to export the bulk of their production as a condition of being allowed to enter the Chinese market. This is the case with Cooper Tires, which agreed to export 100 per cent of its production in return for being allowed to invest in a Chinese tyre factory. The tyre industry is characterised by enormous economies of scale and imperfectly competitive markets in which a few oligopolistic producers divide the market among themselves. It is Chinese industrial policies and not market forces that are currently determining the trade flows and the location of production and jobs to the detriment of the US tyre industry.

Nor is the detriment only to the US industry. Orthodox unilateral free-traders argue that, even if the US tyre workers lose their jobs, the US economy will enjoy a net benefit from lower consumer prices. But this is true only if the shuttered US factories and laid-off workers quickly shift to some other equally productive and well-paid activity. If, as we know, they cannot, the entire economy will suffer a loss of productivity and wages.

This kind of trade is not win-win. Rather it is a classic zero-sum game. It is well-known to game theorists that in such situations a tit-for-tat response is the optimal strategy. Unilateral acquiescence to the aggressive initiatives of another player (the orthodox unilateral free-trade response) is a sure way to lose.

This kind of situation was anticipated when China negotiated its entry into the World Trade Organisation along with most-favoured-nation treatment from the US. These deals specifically called for tariffs on China's exports if they surged in ways that disrupted US industries. Between 2004 and 2008, US imports of Chinese tyres rose 215 per cent while US production fell by nearly 27 per cent and 5,000 US tyre industry jobs were lost. The ITC says China is not engaging in standard free trade and that its actions meet the established criteria and justify imposition of tariffs under the agreed international rules.

If Mr Obama overrides the ITC, he will not be endorsing free trade. Rather he will be encouraging further mercantilist behaviour, more off-shoring of US-based production and jobs, and continued chronic trade imbalances even as he claims to be striving for an economic recovery and the creation of jobs.

This would not be a change anyone could believe in. It would be more of the same simplistic tired orthodoxy that has already taken a heavy toll on US welfare. In this case, paradoxically, the real free-trade position is to impose tariffs. Free-traders should be telling Mr Obama to pass the test by accepting the ITC recommendations.

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