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The Protectionist's Progress: Year 1

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Abstract

President Trump's actions on trade have not quite matched his rhetoric, but the worst may be to come. Though the political opposition to his protectionism is formidable, so are his conviction and determination and he possesses a wide array of instruments to pursue his goals. The trade doctrine he has espoused makes for trade policy instability both at home and abroad. It may lead to a large deterioration in the operating environment of international business. America's trade-dependent industries and her trading partners should not wait. They need to anticipate and deter the administration's actions. Policies must be adjusted to minimize the damage to world trade.

The Protectionist's Progress: Year 1

As delegates prepare for the coming WTO Ministerial in Buenos Aires, can one speak of a Trump trade strategy? Knowing the impulsiveness and unpredictability that typifies this administration, it may be more appropriate to speak of a Trump doctrine rather than a strategy. This is a set of beliefs which – though not always explicitly stated - can be deduced from pronouncement and actions. For lack of a better term, Trump's trade doctrine may be called "compliant protectionism" – a belief in engaging in as much protectionism as is possible while remaining within the bounds of the law. The credo is that reducing imports and discouraging American firms from investing in plants overseas is in the national interest. This requires use of all measures that the law allows, pushing out the envelope of what is permitted under the law, and, if necessary or opportune, to withdraw from international treaties.

Enough time has elapsed since the President's trade team has been in place, and there are enough Department of Commerce decisions and USTR position papers to outline the new trade doctrine in some detail. This is what this brief intends to do. Even more than usual, it is important to pay attention to the facts rather than the words, and the facts, as it turns out, are less alarming than the words – the bite is not as bad as the bark. However, these are early days and, as I argue below, Trump's approach to trade is both a recipe for an unstable trade policy in the United States and is destabilizing for the world trading system. Pursued to its logical conclusion in the world's largest economy and the architect of the post-war trading system, Trump's trade doctrine points to a major deterioration in the openness and predictability of world trade.

Principles

The Encyclopedia Britannica defines mercantilism, a system of economic theory and practice common in Europe between the 14th and 15th century, in the following terms: "...trade balances must be "favorable", meaning an excess of exports over imports. Colonial possessions should serve as markets for exports and as suppliers of raw materials to the mother country. Manufacturing was forbidden in colonies, and all commerce between colony and mother country was held to be a monopoly of the mother country...". (2016) If one substitutes the word "colonies" with one that is more attuned to the times, such as "suppliers" this definition fits Trump's view of trade quite well. Some of the principles on which this view is based are articulated explicitly by Trump and his team, others can only be discerned from their actions. The principles, so derived, are:

- Focus on bilateral negotiations. As the world's largest importer and sole superpower, the United States can obtain the best terms from bilateral deals where coalitions opposing it are not possible. In this light, bilateral negotiations with smaller economies are likely to yield the best terms. The bilateral preference implies, of course, downplaying the importance of the WTO and other multilateral processes. The ongoing NAFTA trilateral negotiation is an exception, accepted reluctantly.
- Reduce bilateral trade deficits. Bilateral trade deficits, such as those that the United States runs with China, Mexico, Germany, Korea, and scores of other countries are not the natural result

of economic forces, of evolving comparative advantage in a highly integrated world economy, but rather the outcome of unfair trade practices abroad and of ill-conceived trade deals which penalize America.

- Create “policy space”. This concept is historically associated with poor and vulnerable countries who ask for longer implementation periods and resist binding their tariffs in the WTO. In Trump’s trade doctrine the demand for policy space is meant to maximize power. It consists of using all types of trade remedies as allowed under US law to the maximum possible extent. It is meant to remove legal obstacles to raise trade barriers at home and to force partners to lower theirs. It consists of undercutting or removing judicial and arbitration processes, and to impose sunset clauses in trade agreements. Ultimately, the quest for policy space may require exit from trade agreements and even from the WTO.
- Negotiate from a maximalist position. If negotiations fail, that creates even more policy space.
- Be unpredictable. This is designed to obtain maximum concessions from trading partners fearful of losing out on their most important market. It is also designed to deter American and foreign corporations from undertaking investment overseas to export to the United States by making them riskier.

Trump’s trade doctrine does not leave much room for the normal “win-win” view of trade negotiations, which aim to exploit export markets abroad while yielding access at home in return. This is especially puzzling in the case of the United States. After all, the country regularly ranks at the top or near the top of competitiveness rankings – such as those compiled by the World Economic Forum (2017) and the World Bank. The United States is the world’s most productive large economy, is still the largest exporter of goods and services (China was a close second in 2016) and its current account deficit is near 2.5% of GDP, widely considered to be an entirely sustainable level. (World Development Indicators) The United States is not only increasingly self-sufficient in energy and the world’s largest exporter of agriculture, it holds the lead in several of the fastest growing high-tech sectors of world trade and in business services. Five of the ten companies with the highest market capitalization are global technology companies and all five are American. Perhaps Trump and his team are so wary of depending on foreigners’ willingness to buy American products that they prefer to deploy instruments over which the United States has direct control, such as trade remedies. Or perhaps they are wary of trade because they are overly concerned with manufacturing as distinct from services and agriculture, and – within manufacturing – are overly concerned with “sunset” industries such as coal and steel. Given this mindset, the Trump trade team clearly find it difficult to imagine that the United States can prevail over competition from overseas. These beliefs fly in the face of the evidence, but they are now being translated into action.

Actions

Donald Trump’s intentions cannot be doubted. Immediately after his election he took the momentous step of withdrawing from the Trans-Pacific Partnership. He arm-twisted American firms to keep jobs at home and cease investing in Mexico. He has nominated trade skeptics,

2. Arguably, mercantilism peaked in the mid- to-late 17th century with Jean-Baptiste Colbert as the ideas Adam Smith developed in “The Wealth of Nations” gained currency.

Commerce Secretary Wilbur Ross and Trade Representative Robert Lighthizer to their key positions, and insisted on immediate renegotiation of the North-American Free Trade Agreement, “the worst deal ever”. With these measures, he established his credentials as the first openly protectionist United States President in memory. The Smoot-Hawley tariffs were signed into law by a profoundly ambivalent Herbert Hoover in 1930 amid mass unemployment. Trump, in contrast, is an enthusiastic advocate of tariffs at a time when the American economy is enjoying robust growth and full employment.

In evaluating his progress, one can start with what I believe is the most important, which are the things that the Trump administration has not done. It has not imposed a punitive tariff on China nor branded China a currency manipulator, as Trump threatened to do during the election campaign. Instead, the administration has taken credit for some large export orders (unclear how much they are additional to China’s prior intentions) while assiduously courting China for help on North Korea, and China has joined in the imposition of sanctions against that country. The administration has not imposed a punitive tariff on Mexico, and Trump has not (yet) pulled out of NAFTA as he has threatened many times and continues to do. Nor has the United States insisted on negotiating separately with Canada and Mexico. Instead, NAFTA negotiations are now in the fifth round and the deadline for concluding negotiations has been extended to the end of the first quarter of 2018. Trump has not pulled out of the WTO as he threatened to do during his election campaign, nor has he renewed this threat since his election as far as I know. Instead, the United States will be a participant – albeit a visibly unenthusiastic and pessimistic participant - in the Buenos Aires Ministerial.

Now to what the Trump administration has done. The United States’ offer in NAFTA includes stricter rules of origin for automobiles, with a specific requirement of US content, a five-year sunset clause, a dilution of NAFTA’s dispute settlement procedures, and a demand for increased access to the Canadian dairy market. These offers - especially the first three - are widely seen as unacceptable and could signal either a tough opening bid or an intention to dismantle NAFTA, preferably by having Mexico or Canada walk away from the deal. TPP may be dead, but U.S. negotiators are using parts of the TPP text as a starting point for the revamped NAFTA. They are also declaring an interest in bilateral deals with TPP signatories, such as Japan, which would revive aspects of the agreement. At the WTO, the United States has refused to endorse the filling of open positions on the WTO Appellate body on grounds that its adjudication of disputes has gone beyond what parties had negotiated and in ways that are unfair to the United States. While this complaint predates the current administration, it has been voiced more forcefully and consistently than before by the President himself, including during his recent trip to Asia.

Under the new administration antidumping and countervailing duty investigations have surged to levels 50% or so higher than last year. It is possible that the politicization of these independent, quasi-judicial, and WTO-consistent procedures by the administration have already convinced claimants that they can expect a more sympathetic ear. Or it is possible that claimants have been encouraged by changes in law that preceded Trump and which have made it easier to demonstrate injury. Perhaps more worrisome, solar panel and washing machines producers have initiated safeguard claims under a rarely used but WTO-consistent Section 201 of the Trade Act of 1974. The International Trade Commission has just found that injury to these industries occurred, opening the door for the President to apply duties affecting all imports in those categories, not just those from select companies as in the case of antidumping and countervailing duties.

The administration also initiated an investigation of whether aluminum and steel imports represent

a threat to national security under Section 232 of the Trade Expansion Act of 1962, a possibility also recognized by the WTO, but which some experts believe is so open-ended that if it became more widely used could undermine the system. However, these investigations are now dormant after it was “discovered” that imports of these raw materials come predominantly from U.S. allies. Most recently, the administration has initiated an investigation of China’s practices in intellectual property and technology transfer under section 301 of the Trade Act of 1974. Section 301 can afford the United States a very wide scope to apply retaliatory measures, including raising tariffs. It has not been used in this way since the establishment of the WTO as it is widely believed to be WTO-inconsistent.

The actions taken so far by Trump and his trade team may not yet be as bad as the rhetoric suggests and that many feared. But they make clear that they are operating on very different principles than past administrations, and the continued operationalization of these principles, if pursued, threaten much worse outcomes for numerous constituencies. These constituencies are now resisting.

Resistance

When I last assessed the new administration’s trade stance in the spring, Trump’s protectionist intent was already beyond doubt, and I expected that the opposition would come, sooner or later, from powerful groups. (Dadush 2017) These include Republicans in Congress, especially representatives of the most export-dependent states; the National Security establishment concerned about America’s fraying alliances and unnecessary provocation of rivals; the mainstream business community interested in trade, i.e. exporters, foreign investors, importers of parts and raw materials, retailers, wholesalers, and transport firms; American farmers; and, not least, those trading partners with the greatest capacity to retaliate.

Each of these stakeholders reacted cautiously in the wake of the election surprise, weighing their options in the face of a powerful and unfamiliar new force. As expected, their opposition to Trump’s trade policy has become open and assertive. Some illustrations: Mexico has declared its intention to walk away from NAFTA if certain red lines, such as higher tariffs, are crossed and is preparing to revert to a WTO-based regime that would be far less advantageous to the United States; without specifying its red lines as clearly as Mexico, so has Canada; both countries have stepped up their bilateral discussions with third parties; China and the European Union have threatened to retaliate against any measure that affected them; Japan has taken the lead in negotiating a TPP 11, i.e. TPP without the United States; the United States Chamber of Commerce, the nation’s most powerful business advocacy group, has come out strongly against dilution of NAFTA disciplines and escalated its lobbying in Congress; the security establishment has resisted a major trade policy shift against China (as Trump threatened during his election campaign) and instead pressed for coopting China to put pressure on North Korea; in a closely balanced Senate, influential Republican Senators, namely John Mc Cain and Bob Corker, respectively Chair of the Armed Forces and Foreign Relations Committees, have become vocal critics of Mr. Trump and his policies; lawyers working on behalf of companies and of the Congress have begun devising legal strategies to prevent a unilateral decision by the administration to pull out from NAFTA; and in a survey of all 50 State governors the publication “Inside US Trade” found no one who wanted NAFTA ended. The list goes on.

The opposition to Trump’s protectionism is emboldened by the administration’s many missteps on a wide range of issues. Despite his party holding a majority in both Houses of Congress, Trump’s reform agenda has so far been thwarted in healthcare, the travel ban from Muslim countries, the Mexican

border wall, the move of the United States Embassy to Israel from Tel Aviv to Jerusalem, the reduction of overseas troop commitments, and others. But the measure that will most clearly define the success or failure of his term as President, tax reform, or more accurately, tax cuts, is still in the balance. If he is to make progress on it, Trump can ill afford to alienate key constituencies in the Republican party, such as the fiscal conservatives who will demand that tax cuts be matched by reduced expenditures. Orrin Hatch, who chairs the Senate Finance Committee and is pro-trade, will play a crucial role in pushing for Trump's tax reform. John Cornyn of Texas, the state most dependent on exports to Mexico, is both the pro-trade Chair of the Senate's Trade committee (a sub-committee of the Finance Committee) and the Senate Majority Whip. If and when the Congress votes for tax cuts, Trump's room for maneuver on trade will widen considerably. How much harm can he inflict?

Legalities

The forces arrayed against Trump's protectionism are powerful, but Lighthizer and Ross have plenty of legal space to pursue the agenda advocated by their boss. Congress delegated to the President the authority to negotiate tariffs back in 1934, and with it the authority to withdraw from trade deals. Trump can decide to withdraw from NAFTA giving six-month notice and allow tariffs to return to the WTO MFN level after an adjustment period. Welcome as such a step may be to Trump's base, such a radical measure taken unilaterally would be politically very costly and also subject to legal challenge. Experts differ on this point, but it is possible that a withdrawal decision could not be executed without changing the implementing legislation in the Congress. (WITA 2017) It is also possible for the Congress to pass legislation that would preempt a unilateral withdrawal, though the likelihood of mustering a veto-proof 2/3 majorities of both houses is slim. A unilateral decision to withdraw from NAFTA is certain to trigger a legal challenge by companies hurt by the measure, and it is also likely to elicit a challenge by the Attorneys General of States dependent on exports to NAFTA partners. Pro-trade Congress members could also be pressed to sue on constitutional grounds, though it is doubtful that courts would take up such a challenge. If the plaintiffs prevail, a court injunction would stop the withdrawal process in its tracks. If, difficult as it is to conceive, Trump decided to withdraw not only from NAFTA but also from the WTO, a new tariff regime applying to essentially the totality of US trade would have to be established. Meanwhile, American exporters would be exposed to the risk of higher tariffs everywhere in the world where the United States does not have a bilateral trade agreement (nearly all of its trade if NAFTA is dismantled). There would be an even greater likelihood of disruption, political outcry and legal challenge.

I could be wrong, but I suspect that, should he decide to serve notice to terminate NAFTA – which some in the business community believe is more than likely – there will be enough constitutional impediments and legal challenges that Trump may not succeed in exiting, and if he succeeds it will be only at great political cost. At this stage, an exit from the WTO is almost unthinkable.

Barring these extreme scenarios, the Trump administration's trade policy will continue to have to navigate the same legal channels as its predecessors. This means that the administration will have to abide by WTO disciplines, such as those that bind the tariffs of the United States at around 3% on average and forbid the use of quotas, voluntary export restrictions, and subsidies except in agriculture and only within agreed limits. United States trade law requires Congressional approval of permanent changes in tariffs. Due process in trade remedies such as countervailing and antidumping duties and safeguards requires transparency, and injury is to be determined by the bipartisan International Trade Commission, an independent quasi-judicial government agency. All that said, the President disposes of so

much latitude in the interpretation of both US and WTO laws and with respect to how the administration reacts to perceived infractions by trading partners that there is plenty of scope to protect, to test the law and to push out the envelope of what the law allows.

Consequences

Trump's compliant protectionism is better for the world than the unfettered and wild protectionism promised he promised during his election campaign, and, arguably, it has not done much damage yet. However, in contrast to the pro-trade policies of nearly all post-war presidents, the Trump trade doctrine is inherently unstable and destabilizing in two ways. First, the demand for protection will escalate within the United States, where more and more firms in sectors where the United States is least competitive will be encouraged to seek it. Second, whereas previous administrations kept the trade bicycle moving, helping sustain a virtuous cycle of what Bob Zoellick called "competitive liberalization", compliant protectionism will encourage more protectionism across the world.

The first point requires little elaboration; there are numerous domestic constituencies, from garments to steel to cotton to solar panels to government contractors, which fear imports and have frequently manifested themselves. According to the latest Global Trade Alert, (Evenett & Fritz 2017) which monitors trade measures amid the G20, their efforts resulted in 373 restrictive measures by the United States against exports of the G20 during the whole of Obama's second term and an additional 189 in the months since Trump took office. These constituencies will manifest themselves even more forcefully in the future.

The second point requires more scrutiny. Even if Trump's policy does not result in the United States exiting from major trade agreements such as NAFTA, or in preventing the WTO from effectively adjudicating disputes, it is bound to have a chilling effect on the negotiation of new trade agreements involving the United States, which includes all negotiations at the multilateral level, such as those in trade in services and on environmental goods. Protectionist measures by the United States, consistent with the law or not, will trigger retaliation. There will be instances where third parties seek agreements among themselves to compensate in some way for the inability to make progress with the United States, as in the Japan-EU agreement and in TPP—11. But there will probably be more instances where other countries, many already predisposed to mercantilist thinking, cover themselves in the protectionist mantle of the world's largest economy. Many countries need no encouragement: according to Global Trade Alert, the United States has already been the object of nearly 2500 restrictive measures by the G20 since 2008. Undercutting the legitimacy of the WTO and its dispute settlement will only reinforce the downward spiral.

The destabilizing effect of Trump's trade policy on world trade is compounded by the rest of his foreign policy, which takes a skeptical view of multilateral governance mechanisms generally. Globalization does not exist in a vacuum: it requires the willingness and ability to take coordinated action in the provision of a wide spectrum of public goods which extend beyond trade disciplines but affect trade. Trump's desire to slash foreign aid, diminish the State Department, his decision to withdraw from the Paris climate agreement, and his ambivalence towards NATO affect disparate stakeholders but they all convey the message that international cooperation matters little. Ultimately, open and predictable trade requires a belief that individual countries win from international cooperation. When that belief is absent, or perceived to be absent, and especially in the largest economy and most influential power, the trade edifice is undermined at the foundation.

Which countries will be the biggest losers from Trump’s trade doctrine? To address this question it is important to go beyond scrutiny of changes at the margin, such as those that have materialized to date. Instead, one must imagine a protectionist United States more fully engaged in import-substitution, a nation that insists on vastly reduced bilateral trade deficits, or else.... In that scenario retaliation and imitation across the world would cause trade to slow sharply, potentially grinding down to zero growth (instead of the 4% annual growth currently predicted by the World Bank and World Trade Organization) in 3 or 4 years’ time. Countries will suffer in three distinct ways: many will see prices rise at home and markets for their exports shrink. Productivity growth will slow reflecting reduced competition and innovation. And investment will decline as business confidence deteriorates.

Three sets of countries will be hurt the most. First on the list is the United States, since, as the originator of the protectionist wave, its consumers will be the first to see higher prices and this will happen well before its exports will be hurt by retaliation. The United States’ enormously successful global firms will become constrained in their foreign investment and operation of global value chains. Second on the list are the ten countries with the largest trade surplus with the United States, beginning with China, since they will be the first target of America’s protectionism (Chart 1). As world trade slows, third on the list are all countries with very large shares of trade in GDP (Chart 2), such as Singapore and Hong Kong. These tend to be some of the smaller and most open economies, many of which are poor developing countries.

Chart 1- Merchandise Trade Balance with the U.S. (Million \$)

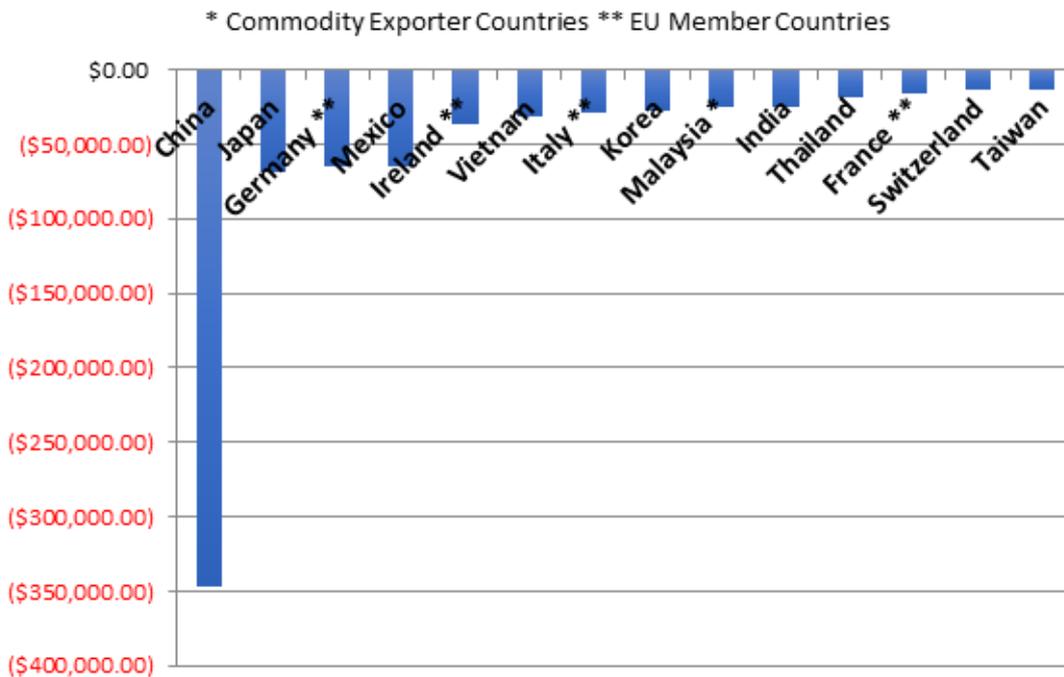
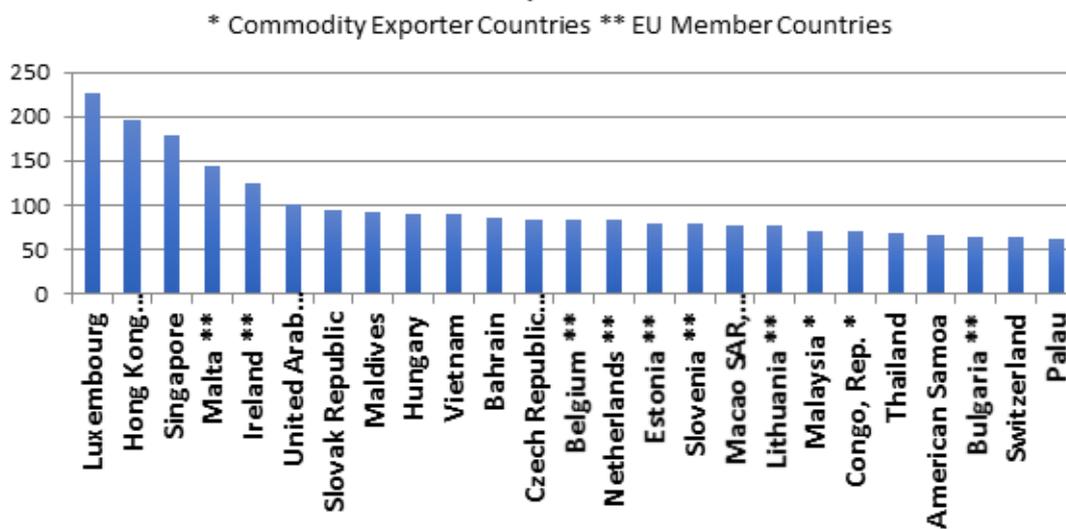


Chart 2- Exports of goods and services (% of GDP), 2015



Among the economies listed in Charts 1 and 2, some will suffer less than others. For example, members of the European Union, which one can safely assume will retain open trade within the Union, will be sheltered to a degree. Exporters of energy and non-food raw materials will also be sheltered to a degree since countries tend not to place high tariffs on products they need but cannot produce. To be sure, if, as is likely, the protectionist wave causes a big deterioration in business confidence, that will result in a deep global recession and slower global growth in the long-term, and everyone will be hurt.

Policies

How should pro-trade constituencies in the United States react? Pretty much as they have already done to date – lobbying and preparing for judicial challenges – but in my view with far greater urgency. It is important that the CEOs and heads of industry groups that are most concerned take a visible personal stand, and not just in the form of anonymous position papers.

What can countries that are deeply committed to the world trading system as we know it, do? There are no easy answers, of course. A central question is whether Trump’s trade doctrine and his “America First” world view is a temporary aberration or whether it signals a difficult-to-reverse return to the isolationism that defined the American Republic during the 19th century and up to World War 2. Such a course cannot be ruled out, since the turn inwards of large parts of the United States’ electorate can be attributed in part to long-term wage stagnation among a large majority of workers, as well as high and rising income inequality, and these trends are unlikely to be reversed soon. At this stage it is uncertain whether Trump’s protectionism will radically alter America’s openness to trade or whether it will be contained by opposing interests as have many of his other policies. And if he does succeed, it is not certain whether his successors will reverse his policies or follow in his steps. But the United States’ trading partners cannot afford to wait. Here are my recommendations.

Faced with exorbitant demands, countries engaged in trade negotiations with the Trump administration such as Mexico and Canada should persist and not walk away. Let the Trump administration do the

withdrawal and explain its decision. Let them face the full brunt of opposition to its trade policies at home.

The United States' major trading partners should reexamine their own policies and ask whether the United States, which remains among the world's most open economies today, has genuine grounds for grievance. It is striking, for example, that China is now touting itself as the champion of globalization even as its average MFN applied tariff is 9.9%, almost 3 times that of the United States, and 16% of its tariff lines exceed 15%, against less than 3% in the United States. While China is ranked 78 in the World Bank's ease of doing business, the United States is ranked 6. It is also surprising to see Germany's policy-makers lack of introspection as the country's current account surplus exceeds 8% of GDP and its car makers conquer the world while their home market (the European Union) is protected by a 10% tariff, nearly five times that of the United States.

Countries need to renew their commitment to the WTO and multilateralism more generally, and make every effort to co-opt the United States, but, if necessary, to find ways to proceed without the United States. Their initiatives should be highly visible to the American public. Policy-makers should be proactive and quickly start reshaping the institutions of world trade as they would like to see them. At the same time, the United States' major trading partners should make clear that they will retaliate if their trading interests are imperiled. It should always be evident to the American public, and especially to the U.S. Congress that the Trump administration's trade policy has consequences in terms of lost markets, lost jobs, and foregone profits.

It is vital that countries continue to build trade alliances among themselves, exploiting especially the potential of consolidating trade pacts around the largest trading nations or blocks, namely the European Union, China, and Japan. China, which is headed towards being the world's largest trading nation by a wide margin a few years from now, could play a far more assertive leading role in the conduct of trade relations and in the revitalization of the WTO. However, to do so, it must address its own internal contradictions. If China is to be the leading advocate of free trade, taking over the mantle held by the United States (and long before that by the United Kingdom), it must first learn to practice free trade at home.

The battle for the open and predictable trading system as we know it is joined. Winning it is in everyone's interest, beginning with that of the United States. But the outcome is far from a foregone conclusion.

3. In a recent brief, I argue this point (Dadush, 2017). The trends in technology and globalization that are the most important underlying cause of wage stagnation in the United States are likely to persist.

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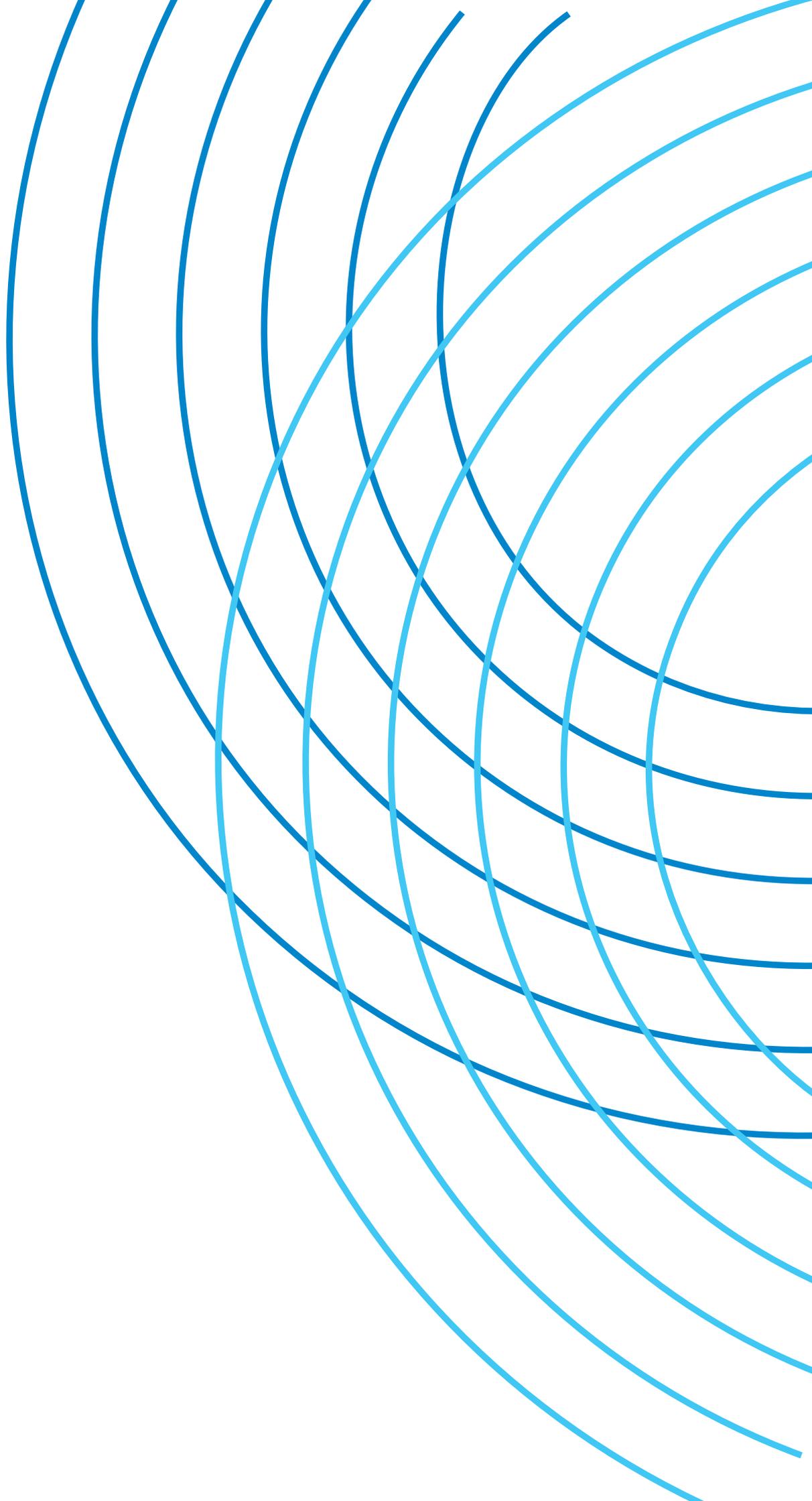
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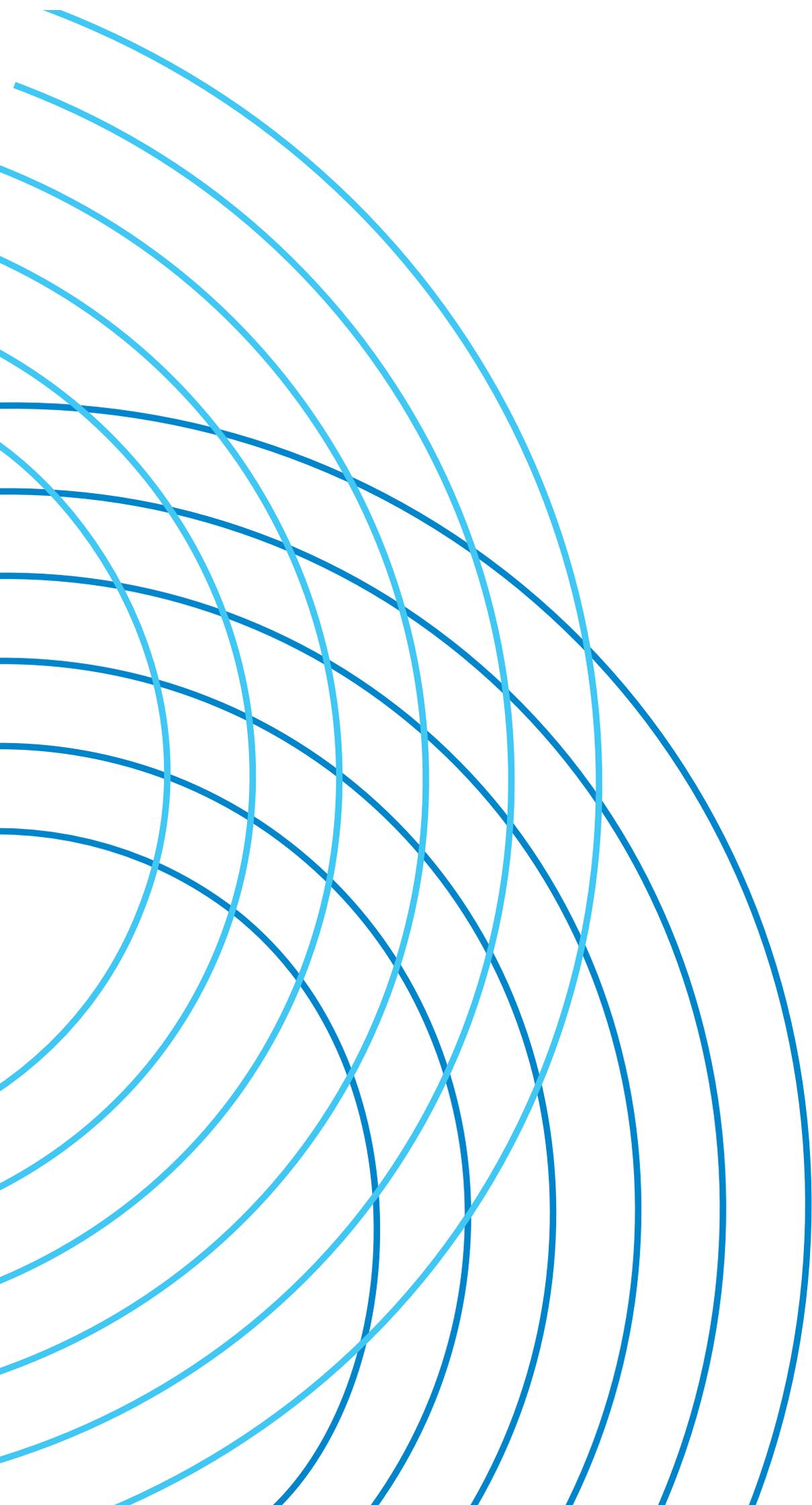
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