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The two types of Trump protectionism

- The president will not get his wish for a weaker dollar

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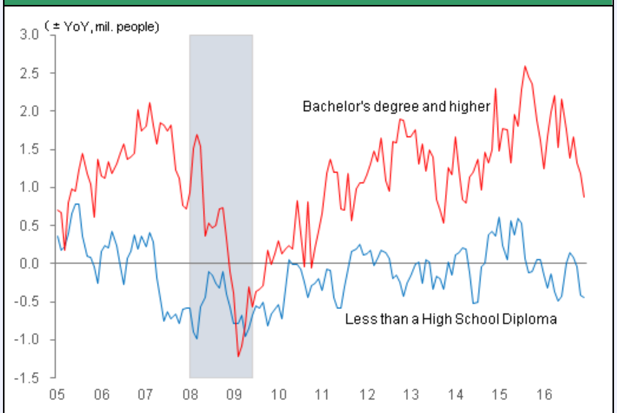
Are the president's outrageous statements actually a carefully orchestrated strategy?
Contrary to the expectations, President Trump has clearly become a person who makes good on his promises. Executive orders have been signed to withdraw from the TPP and to renegotiate NAFTA. In addition, he has angered Mexico with his hostile actions like signing an executive order about building a border wall. The president is obviously determined to carry through with his campaign pledges even if they are rude or offensive. He has also stated that barriers in Japan create an unfair situation that prevents the United States from selling automobiles in Japan. But this is a big mistake based on the one-sided standpoint of (probably) Ford. This statement most likely shocked all of the participants in the automobile market. If President Trump really believes this, there are serious doubts about his thinking. On the other hand, if the president is merely bluffing, he is starting out by intimidating the people who will negotiate with the United States. So this does not bode well for upcoming events. However, President Trump receives a passing grade if his provocative statements are actually carefully orchestrated tactics aimed at negotiations with China.

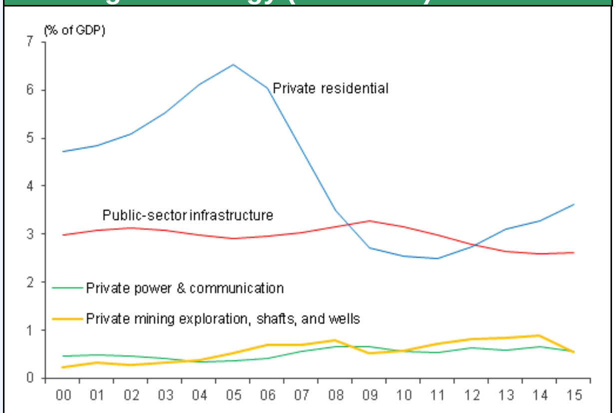
The primary aim of protectionism – Create jobs for lower-skilled US workers
Aside from this matter, we need to thinking about the two very different types of President Trump's trade measures, which appear to be based on protectionism. Creating jobs for US workers is the first type. The main target is lower-skilled white workers in the US Midwest, a particularly vulnerable population segment. Since the global financial crisis started in 2008, there has been a steep drop in employment opportunities for relatively unskilled workers. Dissatisfaction among these people has grown as a result. As Figure 1 shows, jobs for manual laborers without advanced education have declined even though the US is at full employment with an unemployment rate of 4.7%. Jobs for Midwestern lower-skilled white workers have been taken away by a number of factors. Most significant are a large downturn in housing investments, lower public-sector infrastructure spending in order to cut budget deficits, lower energy investment due to declining crude oil prices and strict environmental regulations. President Trump plans to restore job opportunities for these workers by boosting infrastructure spending, raising investments by easing energy regulations, and increasing home construction by lowering regulations on the financial sector. The president's policy is based on sound reasoning and will probably succeed.

Figure 1: US employment growth by educational attainment



Source: BLS, Musha Research

Figure 2 : US investment in infrastructure, housing and energy (% of GDP)



Source: BEA, Musha Research

Protecting and attracting factories

In association with these measures to create US jobs, the first type of protectionism is aimed at making US factories more competitive. NAFTA has prompted US manufacturers as well as manufacturers of Japan, Germany and Korea to move factories to Mexico. One result was the rapid emergence of an automobile industry in Mexico and the outlook for fast growth of auto exports to the United States. Propelled mainly by exports, automobile production in Mexico has grown from 2.26 million vehicles (of which 1.86 million were exported) in 2010 to 3.46 million (2.76 million exports) in 2016. Based on the plans of major automakers, production in Mexico is expected to be more than 5.8 million vehicles in 2020. Most significantly, the US Big Three plan to raise output in Mexico from 1.63 million vehicles to 2.49 million, an increase of 860,000, while lowering US production from 6.41 million to 6.14 million. Incidentally, Japanese, German and Korean automakers plan to increase production in the United States. President Trump wants to renegotiate NAFTA, which is the main culprit for the enormous loss of US automobile production, in order to stop factory closings. TPP has a local content ratio of 45%, which is far below NAFTA's 62.5%. This is sparking worries about more overseas shift of US factories and is the biggest reason for President Trump's decision to withdraw permanently from the TPP.

Protectionism and tariffs will only make the dollar even stronger

Protecting US factories is also the goal of establishing a border tax. Although there are minor differences, the Trump administration and Republic Party believe that a border tax will make US factories more competitive by subsidizing exports and imposing a penalty on imports. It is easy to conclude that holding down imports while boosting exports will cut the trade deficit. However, Harvard professor Martin Feldstein said this is not true in a January 9 Wall Street Journal article. Dr. Feldstein explained that the trade balance is determined by the balance between the investments and savings of individual countries. A border tax will not alter the trade balance because it will have no immediate impact on investments or savings. Therefore, the benefit of a border tax will obviously be offset by a shift in currency exchange rates. If there is a 20% corporate income tax and a 20% border tax, the dollar should appreciate 25%.

Barry Eichengreen, professor at the University of California and a leading authority on international economic says, "Forces similar to the ones in Reganomics that drove up the U. S. dollar are now strengthening the U. S. dollar. If import duties are raised in this environment, inflationary pressures will strengthen and push up the U. S. dollar even further," (Financial Times, January 26)

For these reasons, any benefits of trade restrictions and higher tariffs will be eliminated by the depreciation of currencies of countries that are trading partners. Ultimately, there will be no change in competitiveness. This is the reasoning of orthodox economics. In fact, the Mexican peso has plunged about 20% following the election victory of President Trump, who wants to renegotiate NAFTA. A weaker peso has made factories in Mexico more competitive. If the president wants his protectionist initiatives to make US factories more competitive, he will have to limit the decline in the currencies of US trading partners. But this will be virtually impossible to accomplish.

Once this legitimate economic logic is reflected in foreign exchange markets, President Trump's protectionist initiatives will make the currencies of trading partners even weaker. And the yen will be no exception. Enactment of trade restrictions and higher tariffs to make Japan's highly competitive cars less appealing will cause the yen to depreciate. The yen has been appreciating since President Trump began talking about protectionism. However, this is no more than an illogical Pavlovian response due to the widespread perception that existed 20 years ago that Japan-US trade friction (criticism of Japan) results in a stronger yen. There is no way that the yen will appreciate regardless of how many threats President Trump makes.

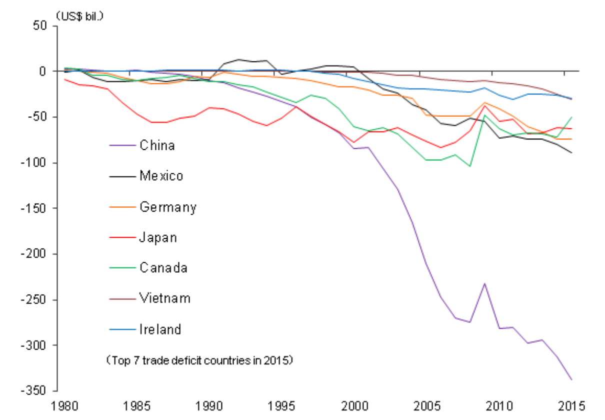
The second goal of protectionism – Contain China

The second and even more important type of President Trump's protectionism involves trade friction with China, an issue that will probably become even bigger. Since this type of protectionism is firmly rooted in geopolitical objectives, the conclusion may be bitter and belligerent. There is a strong desire in Washington to contain China. For instance, Senator Schumer, the Senate majority leader of the Democrats, wants President Trump to designate China a currency manipulating country. The president named University of California professor Peter Navarro to be director of the new National Trade Council. In his book “Crouching Tiger: What China’s Militarism Means for the World,” he explains that no one should expect a change in China, under single-party Communist rule, to alter its pursuit of hegemony. Moreover, this pursuit will inevitably lead to a clash between China and the United States. Avoiding this conflict will require weakening China’s economy, which is the foundation for the ongoing strengthening of the country’s military. At the same time, the United States must bolster its own military strength. Dr. Navarro believes the only course of action is to use these preemptive measures to reduce China’s desire to challenge US hegemony.

The view that US support for China caused China to become more brazen

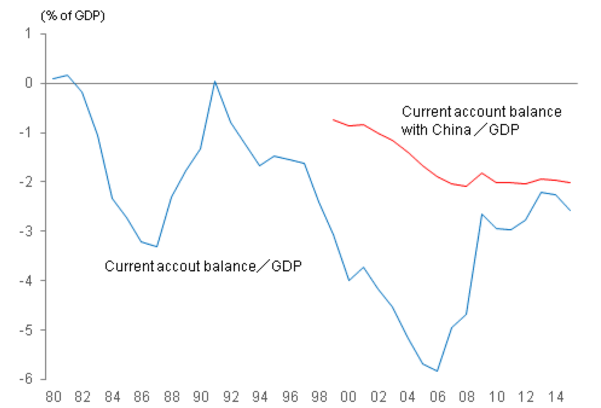
Irrespective of Dr. Navarro’s stance, it is clear that the United States has played a decisive role in the rapid growth of China’s economy. As you can see in Figure 3, China accounts for half of the US trade deficit. Furthermore, the United States has recorded a current account deficit with China over the past decade that has consistently been equivalent to about 2% of the US GDP, as shown in Figure 4. In his book, Dr. Navarro says that US involvement in the Chinese economy has contributed to China’s economic growth and increased the dictatorial power of the Communist Party. Supplying funds to strengthen China’s military is the only thing the United States did. This is probably the correct view of US support for China.

Figure 3: US trading balance by partners



Source: IMF, Bloomberg, Musha Research

Figure 4: US current account balance (with China) /GDP



Source: BEA, Musha Research

Use US-China trade friction to make China less competitive

So what does Dr. Navarro think the United States should do? An article in the January 21 issue of The Economist reports that he believes China should be subject to “appropriate defensive measures.” Exactly what type of measures? This will most likely entail a correction of China’s trade practices (illegal export subsidies, currency manipulation, theft of intellectual property, mandatory transfers of technologies, countless non-tariff trade barriers, and so on) that are inconsistent with international rules, accompanied by US threat of establishing tariffs on all imports from China.

This is similar to events to resolve Japan-US trade friction during the 1980s and 1990s. At that time, the Structural Impediments Initiative was established under the US threat of using Super 301. The aim was to force Japan to compromise and implement domestic reforms. This was a dialogue between two countries rather than a macroeconomic discussion. Robert Lighthizer, the USTR representative, was the deputy trade representative in the Reagan administration. He was at the forefront of trade friction issues involving semiconductors, automobiles, steel and other products. Now the Trump administration is apparently planning to use lessons learned from dealing with Japanese trade friction to handle trade friction with China.

Nevertheless, bilateral talks about trade will not influence the macroeconomic trade balance. Following US-Japan trade negotiations in the 1980s, the US trade deficit with Japan has declined. But there have been big increases in the US current account deficit with China, Germany, Korea and other countries. In fact, the US current account deficit increased as a percentage of GDP up to 2006. If US measures to reduce trade friction with China succeed at correcting China’s unfair trade practices, just as was the case with Japan, China’s industries may become less competitive and the US trade deficit with China may become smaller. However, even though the US trade deficit with

China would decline, this portion of the US trade deficit with China would probably simply be shifted to other countries (and this is a goal of the Trump administration). The result would be a sharp drop in China's economic power and ability to compete. China's trade surplus would plummet and an extended and substantial downturn of the yuan would begin. A stronger dollar and weaker yuan, whether five, 10 or 15 years from now, will be the key to expanding the gap between US and Chinese economic strength to a level that cannot be overcome. If there is a big upturn of the dollar along with a big downturn of the yuan, there will no longer be any possibility of the Chinese economy overtaking the US economy in the foreseeable future. These events would prevent the feared US-China clash for hegemony.

The protectionist measures of President Trump and Dr. Navarro, who heads the National Trade Council, may very well have the geopolitical goal of containing China (there is no doubt this is a goal!) as was just explained. Consequently, although these measures may appear to be protectionism on the surface, we should reach the conclusion that they are actually quite different.

Figure 5: US current account balance and its share to GDP

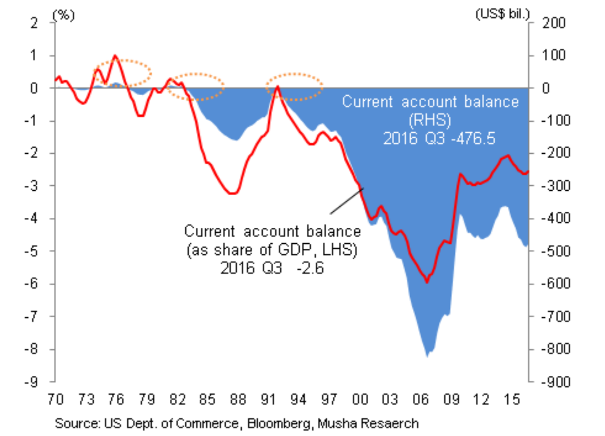
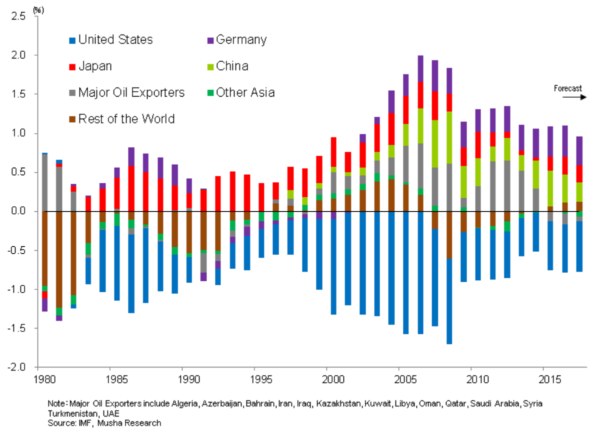


Figure 6: Current account balance share by country/area to world GDP



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