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A Dangerous Game of Trade 'Chicken'

The U.S.-China spat could have global consequences.

By ESWAR PRASAD

The Obama administration's decision to impose tariffs on imports of Chinese tires Friday has been met with a swift and sharp response: China has threatened to retaliate by imposing tariffs on imports of automobiles and chicken meat from the U.S. These measures are of course symbolic and amount to political posturing for the benefit of domestic audiences. But both governments are playing with fire—unless they douse the protectionist flames quickly, they could find things spiraling out of control.

The U.S. administration has backed itself into a corner, promising to be tough on trade and using this as a bargaining chip to strengthen political support for its other domestic priorities. The U.S. may well be on firm ground by the letter of the law in seeking temporary "safeguards" protection from certain Chinese imports, a technical provision that was part of China's accession agreement to the World Trade Organization in 2001.

The problem is that these technical issues are difficult to disentangle from purely protectionist measures, especially in the public eye. Hence, symbolic measures to get tough on China mainly serve as an excuse for China to impose its own explicit protectionist measures or bring implicit measures out in the open.

The Chinese are hardly saints in this process. They have maintained a variety of subsidies and other measures to boost their exports, including an undervalued exchange rate and weak enforcement of intellectual property rights. Beijing continues to rely on export growth to generate job growth, something that their still-dominant and stultified state enterprises are not much good at. Chinese officials also continue to maintain the canard that trade with the U.S. would become more balanced if only the U.S. would lift restrictions on certain high-tech exports to China. That would barely make a dent in the bilateral or multilateral trade surpluses that the Chinese need to run to sustain their growth model.

The risk is that the actions by the two governments may be just the leading edge of more protectionist measures to come from both sides. Indeed, both the U.S. and China have already violated the much-hyped pledges to refrain from protectionist measures that they and other Group of 20 leaders have been making at their various summits. The "Buy America" provision in the U.S. fiscal stimulus bill let the Chinese put in place an explicit "Buy China" provision in their own stimulus package. The U.S. recently imposed duties on certain types of steel pipes from China, at the prodding of the steelworkers' union and a few domestic manufacturers of those pipes. All of this hardly improves the economic welfare of the average American or Chinese citizen.

Each action by either side simply invites an equal and opposite reaction, leaving everyone worse off, except for a small group of domestic producers in each country who are happy to have to face less foreign competition. But the collateral damage might be broader. An escalating trade war between these two large economies has the potential to disrupt the world trading system and set back the fragile global economic recovery that has just gotten started.

Heightened trade tensions between the two countries would also hinder progress on important multilateral initiatives where the two countries play important roles. The U.S. and China invariably set the tone for international discussions on key matters, including initiatives to control climate change, promote reform of the international financial institutions and handle rogue nations like North Korea. A dysfunctional economic relationship between these two countries could spill over into other areas and have huge costs.

The reality is that both economies need each other more than they would like to admit. The Chinese need the U.S. export market to maintain their own GDP and employment growth—a dependence that will only rise with all the new industrial capacity being built up thanks to Beijing's stimulus package. With surging public deficits, the U.S. government needs every bit of financing it can get, including Chinese purchases of U.S. government bonds.

The timing of the Obama administration's action suggests that it is intent on solidifying its domestic political base even at the risk of damaging this important relationship and fostering the perception that it is willing to gut free trade if that's what it takes to push other reforms domestically.

This is a dangerous strategy. Protectionist measures, both explicit and implicit, could be difficult to pull back once they become entrenched. The bigger risk is that the administration might have tipped the China-U.S. relationship into a more contentious and perilous phase. And all for the sake of keeping a few trade unions happy.

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