Tires, Chickens, and Trade – One Week Later

In the week following President Obama's imposition of tariffs on Chinese tires, some commentators expressed confidence that the resulting trade dispute would be well-contained by the two countries and argued that the President had to throw some "red meat" to his trade union supporters. Other, including this writer, expressed concerns that this move could be damaging to the Obama Administration, costly for the US, and risk triggering more significant protectionist actions. The pro-business British magazine The Economist was particularly forceful in the cover story of its September 17 issue, entitled "Economic Vandalism." The article begins with the following: "A protectionist move that is bad politics, bad economics, bad diplomacy and hurts America. Did we miss anything?" Some developments last week are encouraging, but others are not.

Starting with the negative, as was anticipated, workers in numerous US industries also suffering from competition with the Chinese have begun to clamor for similar relief. China, for its part, after threatening action against US chicken and automotive imports, has acted first in the services area, which also is covered by the World Trade Organization (WTO) and is of great commercial importance to the US. China has invoked "defense of public morals" to appeal a WTO ruling against restrictions on the distribution of US movies and other Western media, including the downloading of music. Chinese action against chicken and/or automotive imports may still follow as a result of the anti-dumping investigation China initiated.

The positive aspect of developments so far, including last week's referral to the WTO by China of its complaint against the US action on tires, is that both sides appear to be committed to keeping the dispute within the regulatory framework of the WTO. Thus far, they are following a contract that they both signed, as described below. If the dispute can be kept inside this mechanism, the chances for containing it are reasonably good. However, that will require cool heads on the shoulders of both leaders, in the face of heated nationalist pressures. It also is essential that other countries avoiding joining in with protectionist actions of their own.

Some readers have requested a brief explanation of the legal background to this dispute. China's accession agreement to the WTO included, at the insistence of the US, a provision referring to Section 421, a pre-existing US law, under which, if the US government perceives a large increase in the imports of any Chinese product, sanctions may be imposed to limit the inflow of that product. The test is the following: if "such increased quantities and under such conditions cause or threaten to cause market disruption to domestic producers." Note that there is no requirement to prove that any unfair trade practices existed. We understand that the Clinton Administration gave assurances to the Chinese that the clause would never be invoked.

The process under 421 is the following: once the International Trade Commission (an independent US panel) determines that disruption, as defined by 421, has occurred, it is up to the US President to decide whether or not to impose remedies. Former President George W. Bush declined to impose remedies in the four cases that came to him. Barak Obama decided, on the contrary, to act on the first case referred to him, one where even the US industry in question, America's tire –makers, declined to support the application for import "relief."

This development does not bode well for the ability of the US to assume its usual and probably essential leadership role as champion of the global trading system. We may well see some negative fall-out in the coming days at the G-20 Summit in

Pittsburg. Pledges there to avoid protectionist measures would sound pretty hollow. The Obama administration has thus far taken no action to reinvigorate the moribund Doha round of trade talks, nor the three free-trade agreements pending in Congress with three allies of the US, South Korea, Panama, and Columbia.

There also could be effects outside the trade area where the US needs Chinese cooperation and support, such as the climate-change negotiations, UN sanctions against Iran, and the negotiations with North Korea. Let us hope that those predicting the containment of this matter are correct. If events prove them wrong, the costs could be severe.

As portfolio managers, our greatest concern is the risk that this bilateral trade dispute spirals out of hand resulting in a trade war involving a number of countries. That would certainly drive the global economy back into a deep recession. It is difficult to overstate the importance to the global economy of the generally open trading system, the process of globalization, and the ongoing financial integration. Our current investment strategies are based on our view that the most likely outcome is that this trade dispute remains within the WTO and protectionism does not derail the global economy. Accordingly, we are bullish on the prospects for equities as the recovery of the global economy gathers steam. Our international portfolios currently are fully invested. We certainly will monitor the evolution of this dispute closely.