Worksheet 21.1

US vs. China Trade War – could this be the beginning?

In September of 2009, US president Barack Obama gave a speech on Wall Street in which he reflected on the many lessons America had learned since the beginning of the financial crisis of 2008 and 2009. In his speech, the president urged his audience of investors, bankers and brokers that,

> *Normalcy cannot lead to complacency. Unfortunately, there are some in the financial industry who are misreading this moment. Instead of learning the lessons of Lehman (an investment bank that collapsed in 2008) and the crisis from which we are still recovering, they are choosing to ignore them.*
>
> *They do so not just at their own peril, but at our nation's…*

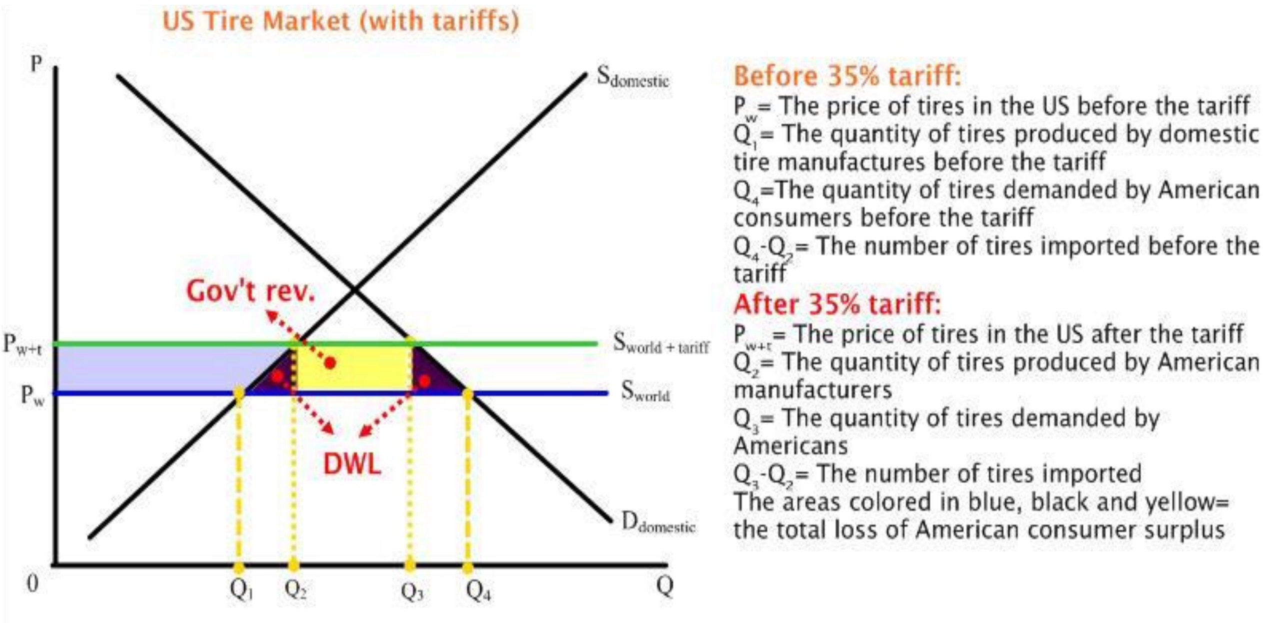
ABC News: President Obama Delivers More Tough Talk to Wall Street on Financial Regulations

In addition to his warnings about the threat posed by overly risky financial markets to the US economy, President Obama expressed his commitment to free trade and 'the fight against protectionism'. He said that 'enforcing trade agreements is part and parcel of maintaining an open and free trading system.'

The enforcement of existing trade agreements Obama refers to is his way of justifying a decision his administration made over the weekend that actually limits free trade between America and one of its largest trading partners, China. In the week prior to this speech, Obama had approved a 35% tariff on automobile tyres produced in China and imported into the United States.

In his speech to Wall Street, Obama decried protectionism and called for expanded trade and free trade agreements which he claimed were 'absolutely essential to our economic future'. But the same week, he supported a protectionist measure aimed at keeping foreign produced goods out of America in order to save a few thousand American jobs.

Obama's support for the tyre tariff can be evaluated using a simple economic model showing the effect the tariff will have on Americans and Chinese producers. The graph below demonstrates how the new tariff would affect various stakeholders.



The key point to notice in the above graph is that a tariff on imported tyres results in a net loss of welfare in America. The blue area represents the increase in the welfare of tyre manufacturers (this could be interpreted as the jobs saved in the tyre industry and the profits earned due to higher prices); the black areas, on the other hand, are welfare loss. Since all tyre consumers in America pay more for their tyres due to the 35% tariff, real income is affected negatively for the nation as a whole.

One effect of the protectionist policy the graph does not illustrate, and perhaps the most serious negative impact of the tariff on America, is the response the Chinese are likely to take to what they interpret as a violation of existing free trade agreements between the US and China. China may choose to implement retaliatory tariffs on certain US products imported to China, such as agricultural goods and high skilled manufactured goods.

The problems with protectionism are myriad. Clearly American consumers suffer through higher tyre prices. In addition, Chinese manufacturers will see sales fall as their product becomes less competitive in the US market. According to some reports, as many as 9,000 workers in the Chinese tyre industry would lose their livelihoods due to declining demand from the US. But the unforseen effects of the US tariff on Chinese tyres is the *retaliatory measures* China may take. If China were to impose new tariffs on American automobiles and poultry, the scenario in the graph above would be reversed, and Chinese consumers would face higher prices, Chinese car part and poultry producers will experience rising sales, while the American auto worker and chicken farmer would suffer.

Free trade tends to result in *net benefits* for economies that choose to participate in it. American tyre manufacturers are certainly harmed by cheap Chinese imports however, America as a whole benefits through cheaper goods, more consumer surplus, higher incomes in China and therefore greater demand for imports of products made in America.

Questions:

1. Why is the Chinese government so upset about a new tax on such an insignificant product as automobile tyres?
2. Some would say that it is a small price to pay for Americans to face higher prices for one product like tyres in order to 'save' 7,000 Americans' jobs. Would you agree? Why or why not?
3. How would the Chinese government's reaction to the US tariff on Chinese tyres lead to possible an even greater loss of American jobs than the continued import of cheap Chinese tyres?
4. If 7,000 Americans were to lose their jobs due to free trade with China, what would we call the type of unemployment experienced by these workers? Is this the same type of unemployment experienced by the 700,000 workers who have lost their jobs each month during the last year of recession in the United States?