Free Trade and Protectionism: The Global Struggle for Economic Dominance

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Abstract

This paper aims to explore the dynamics of free trade and its challenges with a focus on the protectionist policies implemented by leading global economies like the United States and China. Through the lens of David Friedman's Iowa Car Crop thought experiment, it highlights how countries with comparative advantages can access free trade to bolster their economy, yet also examines the reasons nations employ protectionist measures such as tariffs and quotas. The analysis of the U.S.-China conflict and Brexit illustrates how protectionist measures often provoke national retaliation and hinder global economic growth. In addition, this paper underscores the role of hegemonic power in shaping global trade policies and argues how economic strength is developed with competitiveness and innovation rather than protectionism.

The World Bank national accounts data and the Organisation for Economic Cooperation and Development (OECD) national accounts data files were utilized to examine the long-term changes on the shares in world GDP and to analyze the effects of China's dominant production and other events as well. In addition, expert opinion reports written by experts such as Adam Smith and South Korean economist Ha-Joon Chang provided valuable insights into the broader economic implications of these shifts.

I. Introduction

The Iowa Car Crop thought experiment by David Friedman highlights the indispensable role and efficiency of unimpeded trade among nations. It substantiates the consumers' pursuit of economically advantageous commodities and goods and reinforces the principle that free trade empowers countries to harness their unique strengths, namely comparative advantages—be it a wealth of natural resources, an affordable labor force, advanced technology, expansive markets, or other beneficial attributes while engaging in trade with other nations for goods and services that they cannot produce as efficiently.

Just because it is called "free," free trade does not mean that it economically benefits every country that participates in it. Instead, free trade does offer significant profit — only to an extent to a limited number of countries. Therefore, countries impose tariffs, quotas, and other protectionist measures to safeguard their economic interests, particularly when facing trade deficits or hegemonic challenges brought about by countries with substantial power in the global economy, namely China and the United States. These measures, however, provoke intellectual property theft, desire to maintain economic dominance, and damages to domestic industries. Thus, true economic strength should come from competitiveness and innovation, not aggressive protectionism, as protectionist policies can elicit a never-ending cycle of retaliation and hinder economic growth.

II. Challenges to Free Trade

While the benefits of free trade are well-documented, countries implement tariffs and quotas as a means to protect domestic industries, address trade imbalances, promote national security interests, or respond to perceived unfair trade practices.

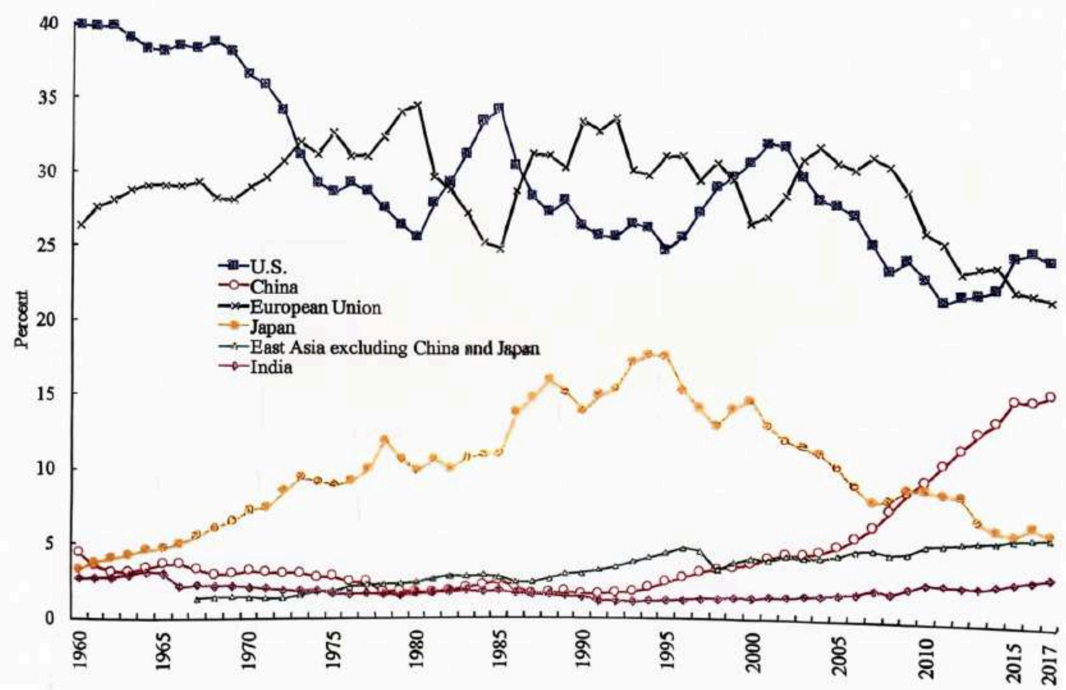
A. Trade Deficit

Although free trade enables countries to leverage their comparative advantages instead of striving to compensate for the economic deficits resulting from inherent disadvantages, countries turn to a protectionist trade policy when trade deficits occur.

The United States and China have engaged in free trade since China opened its market to the world in 1978 and joined the World Trade Organization (WTO) in 2001. China, upon its WTO accession, committed to free trade by providing access to its goods and services markets and reciprocally opening access to markets in other countries. The United States supported China's WTO membership to monitor its communist government, expedite its transition to a market economy, and encourage its participation in shaping global regulations. China presented a new avenue for the US to expand its market influence and anticipate an increase in global GDP.

However, with its formidable advantages–inexpensive labor, a vast market, abundant natural resources, and rapidly advancing technology, China excelled in the free trade market. In 1978, prior to the adoption of economic reform and openness, China's GDP accounted for a mere 1.75 percent of the global GDP, despite its population constituting one-quarter of the world's total. China's share of global GDP gradually began to rise, with accelerated growth following its WTO accession in 2001. By 2017, China's share reached 15.2 percent.

Chart 1.1 The Shares of the U.S., the European Union, China, Japan, East Asia (excluding China and Japan), and India in World GDP



Sources: The World Bank national accounts data and the Organisation for Economic Cooperation and Development (OECD) national accounts data files.

In comparison, the US, which remained the world's largest economy throughout this period, represented 39.8 percent of global GDP in 1960, but its share declined to 24 percent by 2017. This decline was not indicative of a weakened US economy but rather a consequence of the rapid growth experienced by other economies.

However, the US raised concerns about the imbalanced trade relationship favoring China, alleged undervaluation of the Renminbi exchange rate, limited market access for US firms in China, and perceived unequal playing field in Chinese markets that benefits Chinese state-owned enterprises, which the U.S. believes to create unfair trade deficits of $285.5 billion in 2020 where goods exports totaled $124.5 billion and goods imports totaled $434.7 billion.

As a response, the United States implemented tariffs on Chinese goods to address its trade deficit with China in 2018. With an investigation under Section 301 of the Trade Act of 1974, the Trump administration began imposing tariffs of 25 percent on products covering roughly $34 billion of US imports from China in July 2018 and on $16 billion of imports in August. When China retaliated, the US imposed 10 percent tariffs on an additional $200 billion of imports in September 2018, increasing the rate of those duties to 25 percent in June 2019. In September 2019, another $102 billion of imports with 15 percent tariffs were imposed, subsequently reducing them to 7.5 percent upon implementation of the US-China Phase One agreement in February 2020 (PIEE).

These tariffs have alleviated the trade deficit of the U.S. and reduced economic interdependence between the two countries; however, they have triggered retaliatory tariffs from

China, escalating trade tensions between the two largest economies. While free trade generally benefits both trading partners in the aggregate, it does create winners and losers within each country. Unfortunately, the market mechanism itself cannot redistribute gains from winners to losers, necessitating government intervention through taxation and expenditure policies to ensure appropriate redistribution.

B. Protection of Technological Assets

Besides trade deficits, countries charge tariffs and set quotas to protect their technological assets. The Trump administration announced $50 billion worth of tariffs and other penalties on China for its theft of intellectual property (IP), technology, and trade secrets, costing the U.S. economy billions of dollars in revenue and thousands of jobs.

With the “Made in China 2025” initiative announced in 2015, China plans to make itself the world’s top manufacturer in 10 areas, including robotics, artificial intelligence, new synthetic materials, and aerospace. However, in a 2019 report by the U.S.-China Economic and Security Review Commission, the myriad ways of Chinese companies, often supported by their government, were listed to transfer strategic know-how from the United States to China. Additionally, federal agents and cybersecurity experts in the U.S. have identified the digital footprints left along the trails of these attacks and traced this evidence back to specific groups of hackers with proven ties to the Chinese government. The Chinese government's industrial policy, inadequate protection of intellectual property rights, forced technology transfer, cyber theft of commercial and industrial information, and national security concerns became the major barriers to free trade, and the United States implemented tariffs on Chinese goods, invoking Section 301 of the Trade Act in 2018.

C. Protecting Domestic Industries

The United Kingdom's decision to leave the European Union (Brexit) stood in contrast to the EU’s policy of accelerating integration into a single European market. It set a precedent that ran counter to the pro-free trade ideology and systems. The Brexit decision was influenced by various factors, including the UK's persistent trade deficit within the EU, a decrease in job opportunities for nationals due to an increase in immigrants to the UK, and the expansion of the fiscal deficit. Between January and April 2016, the UK’s trade deficit within the EU amounted to 48 billion euros, the largest among the 28 member states.

Even the United States, which has traditionally played a role in propagating and supporting free trade through the World Trade Organization (WTO) and various international organizations, began to transform into a more protectionist stance. The former president Donald Trump was vocal in his skepticism towards free trade agreements, arguing for a reevaluation and, if necessary, renegotiation of all free trade agreements the US had signed, including the North American Free Trade Agreement (NAFTA) and the US-Korea FTA. He openly advocated for protectionist trade policies, blaming the unfair free trade that led to job losses, including the US motor industry, and stifled or even closed-down industries.

D. Economic Power and Trade Hegemony

While the benefits of free trade are often emphasized, the rhetoric can change when a nation perceives itself as losing out in the global market. With an abundance of technology, capital, infrastructure, and other resources, which confer high productivity and a strong economic position, countries prioritize their own interests and strive to maintain their dominance. Frequently, through trade agreements, they open markets in less developed countries for their products while simultaneously maintaining policies that protect their own markets.

Such hegemonic rivalries have been identified throughout history. One of them was seen in the Plaza Accord on September 22, 1985. Finance ministers from France, West Germany, the United Kingdom, the United States, and Japan convened at the Plaza Hotel in New York City. On the surface, the Plaza Accord aimed at curbing inflation, expanding domestic demand, and reducing trade intervention, while central banks from different countries collaborated to orderly depreciate the value of the dollar against major currencies through intervention in the foreign exchange market. However, it was essentially aimed at effectively curbing Japan, which challenged the United States' dominance at the time.

In the early 1980s, Japan was exporting electronic products to the United States, leveraging its superior technology. Among these, Sony's Walkman became a sensation in the US. Japan recorded a tremendous trade surplus, riding on the wave of a strong yen. The United States, grappling with a current account deficit, used the Plaza Accord to alter the dollar-yen exchange rate, which was at 250 yen per dollar, to 120 yen per dollar. This strategic move successfully weakened Japan's export competitiveness.

What did it mean when the exchange rate shifted from 250 yen to 1 US dollar in 1985 to 120 yen by the end of 1987? This effectively placed a 108 percent additional tariff on all Japanese goods being exported to the United States and halved the price of all American products being exported to Japan. From the yen's lowest point in 1975 to its peak in 1995, the currency appreciated by a staggering 3.68 times, which was equivalent to imposing an additional tariff of 268 percent. The Plaza Accord successfully thwarted Japan's burgeoning encroachment into America's economic and cultural spheres at that time.

III. Globalization and Populism Uprising

One of the multifaceted repercussions of globalization is the insidious rise of populists who capitalize on the disillusionment of many workers displaced by job loss. These populists often engage in demagoguery, refraining from addressing the fundamental causes of job loss and instead cultivating the belief among the affected workforce that their unemployment can be attributed to immigrants and free trade.

Globalization has created incentives for companies to relocate their operations to countries with lower regulatory standards and labor costs. This led to a "race to the bottom" as countries competed to attract investment by offering lax regulations and weaker labor protections. Despite cost savings for companies, it led to job losses and the decline of certain industries in high-cost countries.

Populists exploited the concerns and grievances associated with free trade to garner support from workers who feel threatened by globalization and resent as their jobs were outsourced to low-wage countries or replaced by automation and advocate for protectionist trade policies. They propagate free trade as a threat and foreign competition as detrimental to local industries and communities.

IV. Conclusion

Barriers to free trade can be construed as the throes of major powers striving to safeguard their economic hegemony. Historically, free trade itself took root as these powers, having established their footholds in the world, coerced developing nations into market liberalization in pursuit of larger markets. Presently, emerging nations challenging the dominance of the United States, United Kingdom, and other European countries may find themselves, much like Japan losing its latent vigor in the Plaza Accord, inevitably subjected to sanctions within the realm of free trade through protective trade mechanisms, such as tariffs and quotas.

The South Korean economist Ha-Joon Chang used the term “kicking away the ladder" to criticize the policies advocated by developed countries which often propose free market policies and liberalization measures to developing countries while they themselves used protectionist and interventionist policies during their own development. By doing so, they make it difficult for other countries to catch up economically and limit their opportunities for development. As Ha-Joon Chang posits, it is conceivable that the current hegemonic powers are engaged in “kicking away the ladder” in an attempt to stymie the ascendancy of other nations with tariffs and quotas.

By the very principles of free trade, trade deficits are an inescapable reality. A country with certain advantages may have a trade surplus with other countries, while those other countries may have a trade deficit. Adam Smith posited that in a free market, "firms, in the pursuit of profits, are led, as if by an invisible hand, to do what is best for the world." I posit that as long as the world is committed to free trade, the preservation of true hegemony ought to commence with the fortification of substance and competence on the global stage rather than resorting to aggressive protectionist measures. This is predicated on the understanding that such measures inexorably invite an endless cycle of retaliatory actions and unfairly hinder the potential economic growth of a country.

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