US Special

The Trump Trade War Game

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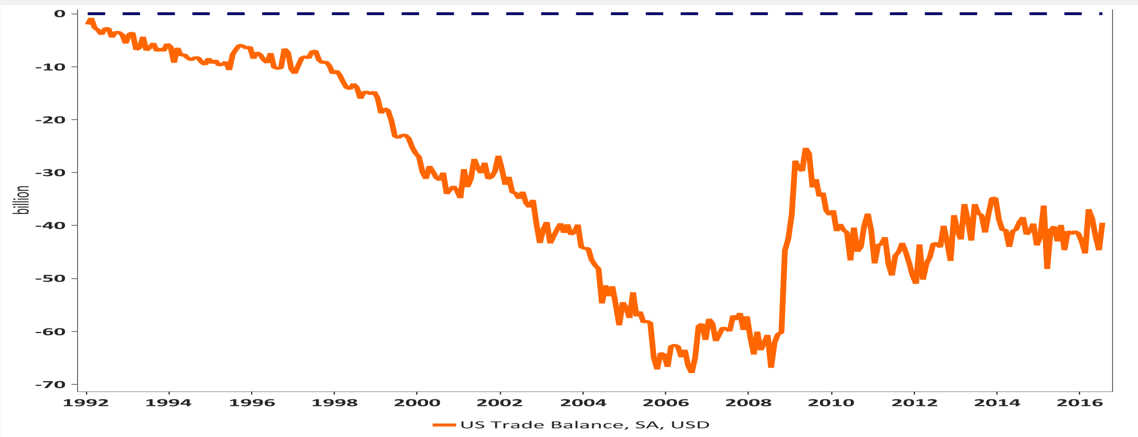
Summary

While the President's fiscal policy powers are limited by Congress, the White House is in the driver's seat when it comes to trade policy. In fact, the President has the legal powers to raise trade barriers without interference from Congress to deal with current account deficits, unfair trade practices, national security threats, national emergencies, and war. From a game theoretical perspective this allows the President to make a 'credible threat' against trading partners. However, the retaliatory measures that foreign governments can take may be highly effective, and no country will be better off in a full scale trade war. This game of brinkmanship has three possible outcomes: victory for the US, a tie, or a trade war. Ironically, victory for the US is positively dependent on a President Trump's perceived "irrationality" and the rationality of the trading partner. If both act rationally it will be a tie. If both behave irrationally, we will have a trade war.

Introduction

In our earlier special The US fiscal policy risk matrix we explained that the new President will have to work with the Senate and the House of Representatives to implement his or her[1] ideas on fiscal policy. In fact, if not both houses of parliament are controlled by the same party as the White House, nothing changes from the current situation of gridlock in Washington. But even if the new President is facing a cooperative Congress, he has to make compromises with his own party. However, when it comes to trade policy, the mitigating influence of Congress on the President is substantially smaller. In this special we discuss the trade policy ideas of presidential candidates Hillary Clinton and Donald Trump, which are both more protectionist than we have seen by their recent predecessors. We summarize the legal powers of the President to take protectionist measures against trading partners without interference from Congress. We take a game theoretic perspective on the actions that a President Trump may take – based on these legal powers – and the reactions that we should expect from trading partners, and their impact on the US and world economy, and financial markets. We analyse the possible outcomes in a three stage game that we call the "Trump Trade War Game".

Figure 1: US trade deficit with the rest of the world

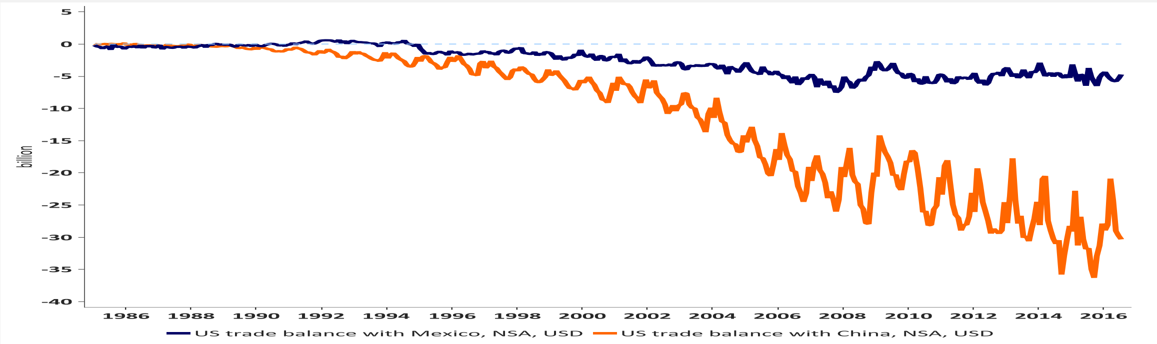


Source: Macrobond

The rise of protectionism in America

Earlier this year in our special The Big Squeeze and the Republican Revolt we explained how stagnating income growth for the US middle class had led to a revolt in the Republican primaries. What's more, at the same time a similar – but in the end less successful – revolt was taking place in the Democratic Party, where Bernie Sanders gave Hillary Clinton an unexpected run for her (donors') money. In order to get the nomination and the support of the Sanders electorate, Clinton has shifted her positions on various policy issues in the direction of Sanders. As globalization is blamed – at least partially – for the decline of the middle class, both Clinton and Trump have taken a protectionist stance on trade policy. This goes against a long bipartisan tradition of trade liberalization, still held by moderate Republicans and centrist Democrats. While Clinton has backtracked on new trade agreements such as TPP (the Trans-Pacific Partnership of the US with 11 Pacific Rim countries), Trump has threatened to take it a step further by ending multilateral trade deals altogether and negotiating bilateral trade deals. He also wants to impose a 35% tariff on Mexican imports – even if this means the end of NAFTA (the North American Free Trade Agreement with Mexico and Canada) –, and a 45% tariff on Chinese imports. While the fiscal policy powers of the US President are limited because budget decisions are made in Congress, trade policy is primarily made in the White House because it is in the realm of foreign affairs. So even though moderates and centrists in Congress may want to push back against protectionist measures taken by the new President, they lack the legal power that they have on fiscal policy. In the next section, we look at the legal powers of the President with respect to trade policy.

Figure 2: US trade deficits with Mexico and China



Source: Macrobond

Legal powers

While fiscal policy is primarily made in Congress, the White House has the upper hand in trade policy issues. Since the President has the authority over foreign affairs, he can cancel free trade agreements, such as NAFTA. By proclamation, he could then raise tariffs on Mexico (and Canada) to the most favored nation (MFN) rate of 3.5%. Subsequently, without exiting from the WTO, he can use a number of 'statutes' to raise tariffs above the MFN rate and impose other import restrictions. These laws give the President the power to raise trade barriers to deal with current account deficits, unfair trade practices, national security threats, national emergencies, and war.

As a first step, the President could invoke Section 122 of the Trade Act of 1974 to raise tariffs to 15% and impose other quantitative restrictions for up to 150 days on countries with which the US has a **current account deficit**. To extend these measures beyond 150 days, he would need congressional authorization. Any challenge through the WTO – the World Trade Organization which has built on the General Agreement on Tariffs and Trade (GATT) that started in 1948 – would take at least 18 months for resolution, and the President could simply ignore any adverse ruling.

He could take a step further by invoking Section 301 of the Trade Act of 1974, which allows the President to impose tariffs and other import restrictions in retaliation for **unfair trade practices**, such as trade barriers and exchange rate manipulation. There is no time limit to these measures. Trading partners could invoke the GATT's Article XXIII Nullification or Impairment to either overturn the measure or get compensation, but this will take at least 18 months. In 2002 President George W. Bush imposed steel tariffs on a range of non-NAFTA countries, including China and EU member states, because of their dumping practices, in order to protect US steel makers and give them time to restructure.

Another step the President could take is to invoke Section 232(b) of the Trade Expansion Act of 1962 – clearly made during the Cold War – and instruct the director of the Office of Emergency Planning to investigate the **national security** impact of specific imports. The GATT allows member countries to depart from their obligations under these circumstances through Article XXI Security Exceptions. Therefore, it will be difficult to challenge this measure in court. However, trading partners could seek compensation through the GATT's Article XXIII, but this will take at least 18 months. In 1971 President Richard Nixon used this law to impose a 10% surcharge tariff for three months as part of a range of policy measures to jumpstart the US economy through the so-called 'Nixon shock'.

The President can even go further by declaring a **national emergency** and invoking the International Emergency Economic Powers Act of 1977 (IEEPA). Raising trade barriers for this reason would make it difficult to overturn because of the GATT's Article XXI Security Exceptions. However, other countries could seek compensation through the GATT's Article XXIII Nullification or Impairment.

The final step would be for the President to use his **wartime powers** through the Trading with the Enemy Act of 1917 (TWEA). This statute does not require a congressional declaration of war and is not limited to enemy nations. So as long as the US is engaged in war anywhere in the world, TWEA can be used to raise trade barriers to Mexico and China. It will be difficult to challenge these measures in a US court or through GATT (because of Article XXI Security Exceptions), but compensation by trading partners could be sought based on GATT's Article XXIII Nullification or Impairment.

Preliminary injunctions sought by US companies because of 'irreparable harm' are likely to fail because of the statutes that would justify the President's trade policy measures. Note that all these measures are possible without the US leaving the WTO.

Table 1: Legal powers of the US President to raise trade barriers

Statute	*Trigger*
Section 122 of the Trade Act of 1974	Current account deficit
Section 301 of the Trade Act of 1974	Unfair trade practices
Section 232(b) of the Trade Expansion Act of 1962	National security
International Emergency Economic Powers Act of 1977	National emergency
Trading with the Enemy Act of 1917	Wartime powers

Source: Peterson Institute for International Economics

Note that the President's executive orders and proclamations discussed in this section are all based on statutes that Congress has written to delegate power to the President. This makes them more difficult to challenge in court than executive orders and proclamations that have no basis in statutes (the so-called 'zone of twilight') or that go against the expressed or implied will of Congress. Changing the statutes would also require several years. Therefore, the legal powers described in this section are ready-to-use tools for the new President, at least in his first term.

Bargaining power

From a game theoretical perspective, these legal powers provide the President with bargaining power because they allow him to make a 'credible threat' against trading partners, without interference from Congress. Some of these powers have been delegated by Congress to the President over the years. Once the White House reaches a trade agreement, it will have to be approved by Congress. However, previous presidents were, at least in words – their actions sometimes proved otherwise –, in favor of trade liberalization. In contrast, the new President will take a more protectionist stance.

Note that a President Clinton might halt trade liberalization by not signing TPP, but this would not likely provoke a trade war. She intends to focus on stronger enforcement of existing trade agreements, addressing abuses by trading partners. She would probably start renegotiations on TPP, in an attempt to get a deal that would make it easier to sell to the left wing of the Democratic Party and get it through Congress later in her presidential term.

In contrast, Trump wants to withdraw from TPP altogether and threaten several trading partners with protectionist measures. With respect to existing free trade agreements (FTAs) he intends to direct the Secretary of Commerce to identify and end foreign violations of trade agreements. He wants to take a step further (than Clinton) by appointing the "toughest and smartest" trade negotiators to renegotiate free trade agreements on a bilateral basis. This would automatically lead to a rise in tariffs to MFN rates as long as the renegotiated deal is not confirmed by Congress, which could in practice take several years. More specifically, he wants to renegotiate NAFTA and if that doesn't work, withdraw from it. In fact, he wants to impose a 35% tariff on Mexican imports (even if this means the end of NAFTA). He wants to label China as a currency manipulator, instruct the USTR (Office of the United States Trade Representative) to bring trade cases against China, and apply tariffs consistent with US law against China if they don't stop 'illegal activities'. In fact, he wants to impose a 45% tariff on Chinese imports.

Table 2: Trade policies: Clinton vs Trump

Topic	*Hillary Clinton*	*Donald Trump*
TPP	Renegotiate	Withdraw
Existing FTAs	Stronger enforcement	Stronger enforcement, Renegotiate on bilateral basis
NAFTA	Stronger enforcement	Renegotiate or withdraw
Mexico	Stronger enforcement	35% tariff
China	Stronger enforcement	45% tariff

Source: Rabobank Financial Markets Research

Although the candidates have been less outspoken about TTIP (the Transatlantic Trade and Investment Partnership between the US and the EU), which is still in the negotiation stage, their stance on TPP suggests that there is little appetite for further trade liberalization in general. While the negotiations on TTIP will become more difficult in case Clinton becomes the new President, they will likely end prematurely if Trump wins the elections.

The Trump Trade War Game

We can think of Trump's trade policy intentions as a three stage game between Trump and the trading partner.

- In the first stage, Trump decides to take protectionist measures or not. In the latter case, the game ends in free trade (the current situation).
- In the second stage, the trading partner either retaliates or complies. In the latter case, the game ends in victory for the US and a loss for the trading partner.
- In the third stage, Trump either stays the protectionist course or he abandons it. In the latter case, the game ends in free trade (which is back where we started). In the former case, we have a full scale trade war with enormous losses for all players.

Assuming[2] that a President Trump will start his reign with threats against various trading partners (particularly China and Mexico), there are three possible outcomes.

Outcome 1: Compliance by trading partners (Reagan scenario)

Given his legal powers, a President Trump could make a 'credible threat' against trading partners that he thinks are not trading fairly, such as China and Mexico. By backward induction, these countries may decide that the negative payoff to a full scale trade war is worse than the negative payoff to making some concessions to appease the US. This scenario unfolded in the 1980s when President Reagan – in cooperation with Congress – forced several countries into 'voluntary' export restraints (VERs) on their steel and auto exports. While VERs have become illegal under WTO rules, this episode shows that countries are willing to make concessions on trade if faced with a credible threat. In fact, the VER on Japanese car exports to the US was announced on 1 May 1981, only eleven days before a bill introduced by Senators Danforth and Bentsen to impose import quotas on Japanese cars was scheduled for revision in the Senate Finance Committee. Note that candidate Trump has said explicitly that he would not necessarily have to carry out his threats on trade policy, but that threats were part of the negotiations. The legal powers of the President will actually give him considerable bargaining power because he can deliver on his promises.

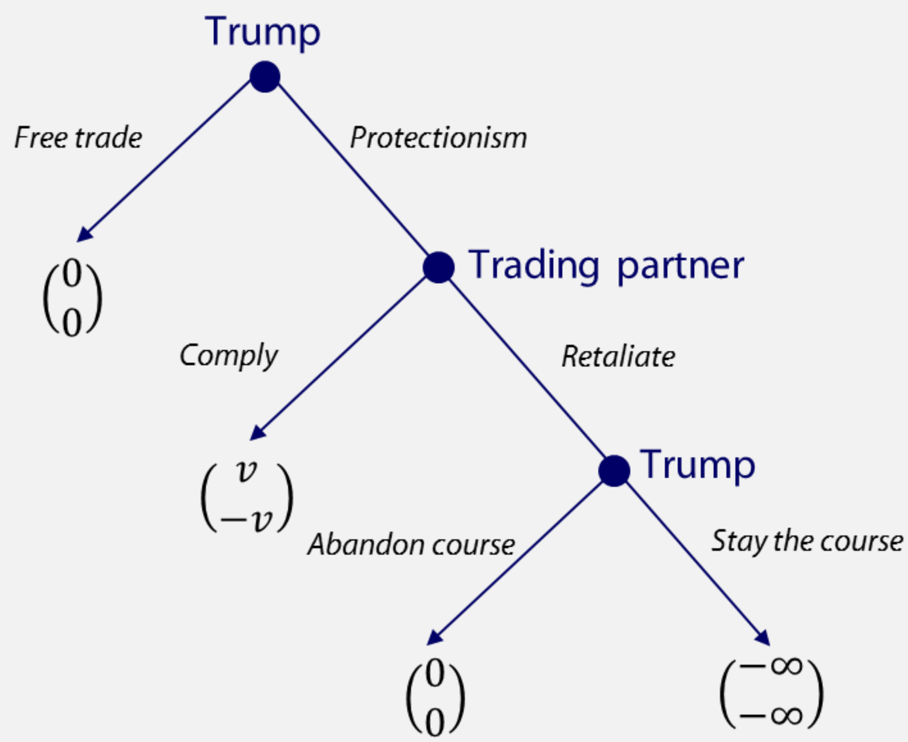
Outcome 2: US stands down after threat of retaliation (Bush scenario)

If trading partners do not comply, and call President Trump's bluff, he may decide to raise tariffs on imports. In response, the trading partners affected by these measures may threaten to retaliate against the US. In 2002 President George W. Bush took anti-dumping measures in the form of tariffs on steel imports from China and the EU. While President Bush ignored an adverse ruling by the WTO, the threat of retaliation by the EU to raise tariffs on a range of US products convinced him to lift the steel tariffs by the end of 2003. This episode shows that the US is not invulnerable to retaliation by trading partners and has been forced to stand down before even before the threat of retaliation was carried out. President Trump may also decide to call the bluff of the trading partners. In the current situation, retaliation may take several forms other than higher tariffs. The most obvious non-tariff measures are the reduction of imports from the US or dropping the protection of US intellectual property rights. However, countries like China and Mexico are also in a strong position to disrupt the supply chain of US multinationals. In addition to these trade measures, retaliation could also take place through exchange rate policies. If the trading partners carry out their threats of retaliation, President Trump will have to choose between abandoning his protectionist course (Bush scenario), or go ahead with a full scale trade war (Smoot-Hawley scenario). When President Bush lifted the steel tariffs he stated that the measures had achieved their purpose (he had bought the steel industry some time to restructure) and that it was time to lift them. President Trump could claim victory in a similar manner.

Outcome 3: Trade war (Smoot-Hawley scenario)

However, if he does not back down, we will have a full scale trade war. The most notorious trade war started with the Smoot-Hawley Tariff Act of 1930 – sponsored by Republican Senator Reed Smoot and House Republican Willis Hawley – which according to many economists deepened and prolonged the Great Depression. While trade wars were never a good idea, the increased internationalization of production processes – encouraged by trade liberalization – have made countries even more interconnected, making trade wars even more harmful to all players involved. Note that Mexico (especially since NAFTA) and China have become crucial in the supply chains of several US multinationals. In the event of a trade war, multinational production processes will grind to a halt and international trade will contract. Businesses will stop investing and start laying off workers. The rise in unemployment will slow down consumer spending and the economies involved in the trade war are likely to slip into recession. When it becomes clear that there are no winners in the trade war – at least not one of the warring parties – reason is likely to prevail and a ceasefire can be negotiated. Note that the expected negative payoffs to a trade war for all players provides an incentive for each player to stand down in an earlier stage of the game, at least if some players act rationally.

Figure 3: The Trump Trade War Game



Source: Rabobank Financial Markets Research

Solution to the game

What is the most likely outcome of this game?[3] Let's solve the game by 'backward induction'. This means that we first consider stage 3. At this stage, Trump has to decide to go to full scale trade war or to abandon his protectionist course. If the trading partner believes that Trump will be rational and therefore blink, he will not be afraid to retaliate in stage 2 to get back to the initial free trade situation. Therefore, the Bush scenario – with the game ending in a tie – can be seen as the rational solution. However, if he thinks that Trump is ready for a trade war, he may decide to comply in stage 1 and accept his loss (and Trump's victory) rather than risk the devastation of a trade war. So the less rational Trump is perceived to be by the trading partner, the more likely the latter is to comply and accept defeat. In other words, the Reagan scenario follows if the trading partner rationally perceives Trump to be "irrational"[4]. Of course, if the trading partner underestimates Trump's resolve and both do not act rationally, we end up with a trade war. Therefore, the Smoot-Hawley scenario can be seen as the irrational solution to the game. The historical precedents (Bush, Reagan, Smoot-Hawley) show that none of the three solutions to the game are merely theoretical.

Table 3: Solutions to the game and rationality of players

	Rational trading partner	*Irrational trading partner*
Rational Trump	Bush scenario: US stands down Game ends in a tie	
Irrational Trump	Reagan scenario: Compliance by trading partner Game ends in victory for US	Smoot-Hawley scenario: Trade war Game ends with big losses for all

Source: Rabobank Financial Markets Research

Note that the 'credible threat' by the US President consists of two elements. In the first place, the President has the legal powers to take protectionist measures, without interference from Congress. In the second place, the President will have to create the perception among the other players (trading partners) that he is willing to go to trade war. Therefore, to make a 'credible threat' Trump's resolve or perceived "irrationality" will be as important as his legal powers. Essentially, this is a 'game of brinkmanship', a dynamic version of the well-known 'game of chicken' in which both players move at the same time. A well-known example of brinkmanship is the Cuban missile crisis during the Cold War.

Domestic opposition: preventing or ending the trade war

Although a President Trump would have the legal powers to take protectionist measures, domestic opposition is likely to grow during the three stage game. This will reinforce the impact of (the threat of) foreign retaliation. The Republican establishment is likely to try to persuade President Trump to change course from the start. Note that House Speaker Paul Ryan, despite his resistance to the current version of TPP, has always been a free trader. More generally, the Republican Party has usually supported free trade, although it has taken protectionist measures at times of distress in certain industries (Reagan and Bush). However, a President Trump is not likely to be persuaded by the time he takes office in January 2017. Initially, when the US raises tariffs domestic importing firms and consumers will suffer. If trading partners retaliate, US exporting firms will be affected as well. Meanwhile, service-providing firms in areas with high concentrations of trading firms are not safe either. The pressure from the business lobby on the White House to abandon course will increase as more industries get affected. American jobs will be lost and if the US economy slips into recession, the public pressure to end the trade war will jump. Due to its high costs to all players, a trade war will not last forever, but considerable damage can be done before it is over.

Impact on economy and financial markets

From a global economic perspective, a return to free trade (Bush scenario) would be preferable. Compliance by the trading partners (Reagan scenario) would be second best. Clearly a full scale trade war (Smoot-Hawley scenario) would be the worst outcome. For the US, the Reagan scenario would benefit certain domestic industries (including employment), but at the cost of domestic consumers who will have to pay higher import prices. The Smoot-Hawley scenario will be devastating to the US economy as well.

Financial markets are likely to go through risk-off episodes as the game is played with a sigh of relief (risk on) when either outcome 1 (compliance by trading partner) or outcome 2 (US stands down) is achieved and a trade war is averted. In case of a trade war, the risk of a recession rises and stock prices and bond yields are likely to be depressed for an extended period, until peace is signed. Note that the timing of the impact will also differ for economic sectors. Initially, when the US raises tariffs importing firms will be hurt. However, when foreign countries retaliate US exporting firms will be negatively affected as well. As time progresses, service providing firms in areas with a high concentration of exporting and/or importing firms will suffer as well.

Conclusion

While free traders may find Clinton's stalling on TPP "deplorable", it would probably only delay the trade agreement, or in the worst case bring trade liberalization to a halt. In contrast, Trump's trade policies would initiate a three stage game with three possible outcomes: victory for the US, a tie, or a "disaster". Fortunately, the "huge" negative payoffs for all players involved in a trade war provide the incentives to compromise. At least, if some players behave rationally.

Endnotes

1) From now on we will use 'his' because the current male candidate has the more protectionist view.
2) This essentially simplifies the three stage game to a two stage game. Note that if we do not assume that Trump will always choose protectionism in stage 1, the rational choice for him is not to take that course.
3) In figure 3 we give the extensive-form representation of the game. For simplicity we assume that the payoffs (top number is payoff for US, bottom number is payoff for trading partner) in case of free trade are zero (baseline case), and minus infinity in case of a trade war. We assume that the gains for the US will be a finite positive amount v in case of victory, and that the losses for the trading partner from complying are –v. By backward induction we can find the subgame-perfect Nash equilibrium, which we show to be dependent on the rationality of the players.
4) Note that being perceived as "irrational" can actually deliver a better result for that player than being perceived as rational. So in that sense it can be rational to be perceived as irrational.

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