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Weaponizing Uncertainty

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The Trump Administration is deploying at scale a new weapon in trade protection – uncertainty. What are the economics of uncertainty and how will it affect trade and investment? We address these questions, drawing on established theory and recent empirical research into the impact of tariff threats on firm behaviour and, conversely, of the trade-liberalizing benefits of reducing uncertainty.

We show that uncertainty matters – it acts like a non-tariff barrier (NTB) that impedes trade and investment. Importantly, unlike actual tariffs, it has no direct price effect and is not subject to the disciplines under the World Trade Organization (WTO) Agreements or under bilateral or regional free trade agreements (FTAs). It is thus only indirectly observed and, by virtue of being indirect, it goes unchecked. Moreover, also unlike tariffs, uncertainty cannot always be easily withdrawn – like a good reputation ruined, its pernicious effects on confidence can take years to unwind.

1 Increasing Uncertainty – Let Us Count the Ways

Under the Trump Administration, US trade policy has been characterized by implausible claims, demands, and threats, which are then retracted, then re-asserted, and so on. One has to monitor the Twitter feed continuously to stay abreast of the latest twists and turns. The list of these uncertainty-inducing actions includes the following:

Withdrawal or threatened withdrawal from major US trade agreements:

- **Trans-Pacific Partnership (TPP):** Trump withdrew the United States from the TPP immediately upon assuming office,[1] then floated the idea of re-joining given suitable (but unstated) "improvements,"[2] then threw cold water on the idea of re-joining.[3]

1 Solis (2017).

2 Ungku and Greenfield (2018).

3 Reichert (2018).

- **North American Free Trade Agreement (NAFTA):** The Trump administration triggered the renegotiation of NAFTA while adopting as negotiating objectives a set of "poison pills" that its negotiating partners cannot accept.[4] It set impossibly short deadlines that were routinely extended when not met and sustained a rhetoric that the current NAFTA is a "seriously flawed" agreement – notwithstanding widespread commitment to NAFTA by US stakeholders.[5] Key negotiating demands of the United States include the elimination or effective evisceration of NAFTA features aimed at increasing confidence in market access – the Chapter 19 binational panel review for trade remedy actions and the Chapter 20 state-to-state dispute settlement mechanism.[6] With no apparent "landing zone" for the NAFTA negotiations, the agreement cannot be signed, yet neither can it be killed in the face of stiff domestic US opposition to its termination.

Undermining the global institutions of rules-based trade:

- **World Trade Organization**: By refusing to affirm new WTO Appellate Body members,[7] the US undermines the ability of the WTO dispute resolution function to continue in the long-run. At the same time, the US has made its cooperation contingent on addressing complaints concerning the orientation of WTO activities that would require a significant negotiation, but it has provided no support for launching this type of negotiation.[8]

Threatening tariffs on US imports (under provisions of US law that had been moth-balled by previous administrations):

- **"National security" tariffs:** The US announced tariffs on imports of steel and aluminium based on Section 232 of the Trade Expansion Act of 1962, which allows a president to act unilaterally if national security is at stake, an implausible framing of these trade restrictions given that they mainly targeted long-time US military allies.[9] Seemingly perversely, the tariffs target production inputs with price increases that also threaten the viability of US producers that require steel and aluminium as inputs into their products. Confusion reigned in the days and weeks that followed the announcement of the tariffs, as US allies and US importers alike scrambled for exemptions. The European Union got a temporary reprieve and began negotiations to avoid a larger trade war; Canada and Mexico were also given reprieves, but only conditional on a NAFTA deal being struck on terms congenial to US demands; China was left stuck with high tariffs on steel and aluminium. Tensions rose and markets fell with China's announcement of the "ginseng retaliation" – import tariffs on $3 billion worth of an odd collection of steel tubing, apricots, and ginseng.[10]
- **Demands for managed trade:** The US announced a massive new tariff of 25% under the unilateral section 301 of the Trade Act of 1974 on US$ 50

4 MacDonald (2018).

5 See, e.g., US Chamber of Commerce (2017).

6 Importantly, Chapter 11 on investor-state dispute resolution has not been targeted by the United States, likely because it is heavily supported by US businesses, due to the fact that a US investor has yet to lose a Chapter 11 dispute. Canada, on the other hand, has shown itself to be markedly against this chapter and is being pressured by its business community to nix it. See May (2017).

7 Suneja (2018).

8 Elsig (2017).

9 US Customs and Border Protection (2018).

10 Larry Elliott and Partington (2018).

billion worth of imports.[11] This action was framed as retaliatory punishment against China based on allegations that US exports and foreign sales were hindered by unfair Chinese trade practices related to technology transfer, intellectual property, and innovation. The US tariffs elicited an announcement by China of a retaliation in like amount.[12] A mission by US representatives to China, which raised demands for managed bilateral trade that included measures described as "impossible for any sovereign country to accept,"[13] ended with no prospect for a truce; a follow-up Chinese mission t o the United States concluded with vague statements about averting a full-blown trade war, but still no concrete announcements; and a further follow-up visit by US officials to China in June 2018 ended without a joint statement, leaving matters up in the air.[14]

- **Escalating trade war:** Trump has requested the development of an additional list of tariff measures on China in the amount of US$100 billion, over and above the US$50 billion already proposed, which would turn the section 301 measures into an all-out trade war.[15]

Outlandish, unworkable proposals to manipulate trade flows that appear deeply uninformed:

- **Bilateral targets for reducing the US trade deficit:** The US has repeatedly articulated trade objectives based on achieving particular bilateral trade balances.[16] Those who understand the source of the bilateral trade balances between the US and other countries have universally dismissed this objective as nonsensical.[17]
- **Bilateral negotiations that would break-up EU policy solidarity:** The Trump Administration specifically targeted Germany's bilateral trade surplus with the United States as a problem and proposed the idea of bilateral negotiations with Germany[18] – a member of the European Union, which, by treaty obligations, can only negotiate trade policy in collaboration with the 28-member European Union. Demanding the achievement of economically nonsensical goals through an impossible negotiation modality is jarring.
- **Threats against US multinationals:** The administration has threatened US companies that shift production abroad with punitive tariffs.[19]
- **Flip-flopping on a policy for China:** The United States imposed export restrictions to a major Chinese cell-phone manufacturer, ZTE, which effectively shut down its operations due to lack of access to US components.[20] These restrictions were over and above a US$1.2 billion fine for violating US extra-territorial sanctions on Iran.[21] The United States then rescinded the ban based on a Chinese

11 Wiseman (2018).

12 USTR (2018).

13 Elliott (2018).

14 McDonald and Wiseman (2018).

15 Holland and Lawder (2018).

16 Bergsten (2017).

17 Gramer (2017).

18 Lopez (2017).

19 Calvert and Miller (2016).

20 Zhong et al. (2018) and Lerner (2018).

21 Riley (2017).

> offer to provide the United States a massive amount of new market access.[22] This flip-flop is extremely odd, because there are really only two ways for the Chinese to expand US market access under global trade rules: either China would have to engage in a major trade liberalization vis-à-vis all WTO partners (to avoid violating its most-favoured nation, MFN, commitments to the WTO) or it would have to enter into an FTA with the United States, which would entail the United States also liberalizing substantially all of its imports from China. Neither of these two solutions seems credible.

So far, few new tariffs have actually been raised by either the United States or by its trading partners in retaliation pursuant to these actions – but tariffs imposed under WTO-sanctioned anti-dumping and countervailing rules and the US Sec. 232 case on steel and aluminium may be only the tip of the iceberg. New US tariff threats continue; automobiles are the latest chapter in this saga.[23]

The evidence suggests, trade and investment have been impacted by uncertainty concerning future US policy; the novel feature is that this uncertainty is being deliberately deployed as an NTB with the stated purpose of forcing US companies to repatriate manufacturing activity that has been moved abroad – including automobile production that moved to Mexico, a NAFTA partner – and to reduce incentives for US firms to invest abroad by raising the risk of their facing restrictions on their access back to the US market.

This larger purpose has also been clearly articulated. Early on, the Trump Administration indicated its intent to repatriate industrial supply chains based on the national security rationale that the United States needed to maintain the industrial skills required to, for example, fix the propellers on US navy submarines (Navarro, 2017). More recently, the section 301 measures have been characterized as necessary for national security on grounds that they defend America's economic security, on which its national security depends.[24]

National security as a rationale for US trade protection is not new: for example, a long-standing US law, the Jones Act, requires ships used for coastal and inland shipping to be built in America and staffed by American personnel, with the express purpose of ensuring the availability of a naval reserve in case of war. The array of actions described above can thus be described as amounting to the "Jones Act on land," with the larger purpose of fundamentally repositioning the United States in the global economy. This has not gone without notice: as Peter Coyle, writing for Bloomberg News, commented: "The US is invoking national security to bust out of the delicate web of trade agreements that it's spent decades carefully spinning."[25]

And uncertainty is the principal tool that is being deployed for this purpose.

2 The Economics of Uncertainty: Theory and Empirical Evidence

Modern firm-level trade theory takes into account the fixed costs of foreign market entry. These fixed costs include such things as obtaining market intelligence, identifying foreign partners, dealing with foreign regulatory requirements, and so forth. In addition, firms considering entry into a foreign market confront uncertainty about success in their foreign ventures,

22 Swanson and Tankersley (2018).

23 Rampell (2018).

24 The White House (2018).

25 Coy (2018).

as they have less knowledge than established firms about foreign markets and the local partners or agents they must engage (information asymmetries) and also because of political risk that market access will be withdrawn or compromised. In the face of uncertainty about market access, not all firms capable of exporting or investing abroad will assume the costs required for market entry and, of those that do, many will make the necessary market-entry investments in fewer markets than they might optimally serve.

In the investment literature, firms are understood as making state-contingent decisions; given uncertainty about future states of nature and at least partial irreversibility of investment decisions, the opportunity cost of immediate investment (i.e., the option value of delaying and accumulating additional information) is included in the firm's cost of investment. As Dixit and Pindyck (1994) emphasize, "hurdle rates" for firm investments are substantially higher than the cost of capital;[26] they suggest that the value of real options is thus very significant, implying uncertainty is also a very significant factor inhibiting investment. Bloom et al. (2007) make the case that uncertainty does indeed make firms more cautious and, further, that this effect is large.

New empirical findings corroborate these theoretical predictions. Research conducted at Cambridge in collaboration with Zhejiang and Nanjing Universities has shown that tariff scares – threats of tariff increases that never actually materialise – discourage new firm and product entry into foreign markets (Crowley et al. 2018). An unintended consequence of a US import tariff on Chinese goods is that it can deflect Chinese goods to other countries (Bown and Crowley 2007). As these deflected imports bounce around the world, the impulse toward protectionism sometimes follows. Echoes of the original tariff can appear in other countries (Tabakis and Zanardi 2016). A second or even third country sometimes raises a tariff on the same product. In this context, the analysis finds that a tariff hike in one foreign market deterred Chinese firms from entering other markets – even when tariffs in other countries were never actually raised.

Reductions in trade policy uncertainty have the opposite effect, changing the way businesses think about foreign markets. Research into events like Portugal's accession to the European Community in 1986 and China's accession to the WTO in 2001 taught us that when businesses felt more confident about their future access to foreign markets, they invested more and took the leap to expand abroad (see Handley and Limão 2015; and Handley and Limão 2017, respectively).

The effect of uncertainty in services market access is brought out in research into the effect of "water" in countries' commitments under the General Agreement on Trade in Services (GATS). Ciuriak and Lysenko (2016) identify the effect of "water" in countries' WTO bindings, as measured by the difference in countries' scores on the OECD's Services Trade Restrictiveness Index (STRI), which measures the restrictiveness of applied measures, and their scores on the GATS Trade Restrictiveness Index (GTRI), which measures the restrictiveness of their GATS bound commitments. Using a gravity model, they find that services trade responds positively both to reductions in applied services trade barriers and to reductions in uncertainty, as measured by water.

Increasing uncertainty about market access has real economic costs. New foreign exporters play a

26 Internal decision-making in firms is based on so-called "hurdle" rates of return that the prospective investment must promise in order for the firm to commit funds. Such hurdle rates are typically substantially higher than the cost of capital to the firm, inviting the question of why firms would not undertake investments with prospective rates of return below the hurdle rate, but above the cost of capital.

vital role in the economy – by nipping at the heels of established domestic corporations and incumbent foreign exporters, they apply competitive pressure that keeps prices low and enhances product variety. In Europe, competition from Chinese imports has been shown to stimulate innovation by European firms (Bloom et al. 2016). Thus, even if countries do not follow through and enter into full-blown trade wars, the mere threat of tariff barriers being erected introduces hidden costs associated with less trade – higher prices, fewer products, less innovation.

3 Is the Trump Uncertainty Effect Reflected in the Trade Numbers?

The Trump Uncertainty Effect does not jump off the page in the first year of the Trump Presidency. US imports and exports both rose in 2017, continuing the trend of 2016, and imports in the 4th quarter of 2017 actually accelerated, expanding the US trade deficit.

So much for uncertainty? Not really. There is considerable inertia in trade due to longer-term contractual arrangements. Moreover, the fiscal expansionism of the Trump Administration worked to expand demand in the United States and by extension in its trading partners in 2017. Further, the intensification of uncertainty has largely occurred in 2018 and this has yet to be reflected in the aggregate trade numbers (See Figure 1).

There are, moreover, indicators that show that markets have moved. In the immediate aftermath of the Trump Administration's announcements of safeguard measures on steel and aluminium imports, US prices of these products soared in anticipation,[27] meaning that buyers entered into contracts for higher-priced steel and aluminium supplies from domestic US suppliers, passing over lower-priced offers from international sources, in order to avoid the risk of having to pay still higher prices following the (uncertain) imposition of duties.

Further, firms facing international investment decisions have paused: foreign direct investment (FDI) into Canada in the 4th quarter of 2017 was at a decades' low level. UNCTAD (2018) reported that global FDI inflows into developed countries were down substantially in 2017. Investment, which is predicated on longer-term market access is precisely where heightened uncertainty would be expected to be most visible.

And in China, Internet giant Alibaba moved quickly in May 2018 to buy a Chinese chip manufacturer,[28] evidently with the aim of developing capacity to replace US components in Chinese technology products to insulate China from export bans of the sort that at least temporarily have shut down ZTE.

Global trade alliances also appear to have been affected: the Trump tariffs on China would be tariffs on East Asian supply chains in general, affecting Japan, Korea, Taiwan, and other East Asian economies. Accordingly, perhaps the revival of free trade talks between China, Japan, and Korea (the so-called "CJK" negotiations) should be attributed to the shadow of uncertainty cast by US policy. A similar observation may be made in respect of Mexico's renewed interest in its Latin American trade relations.

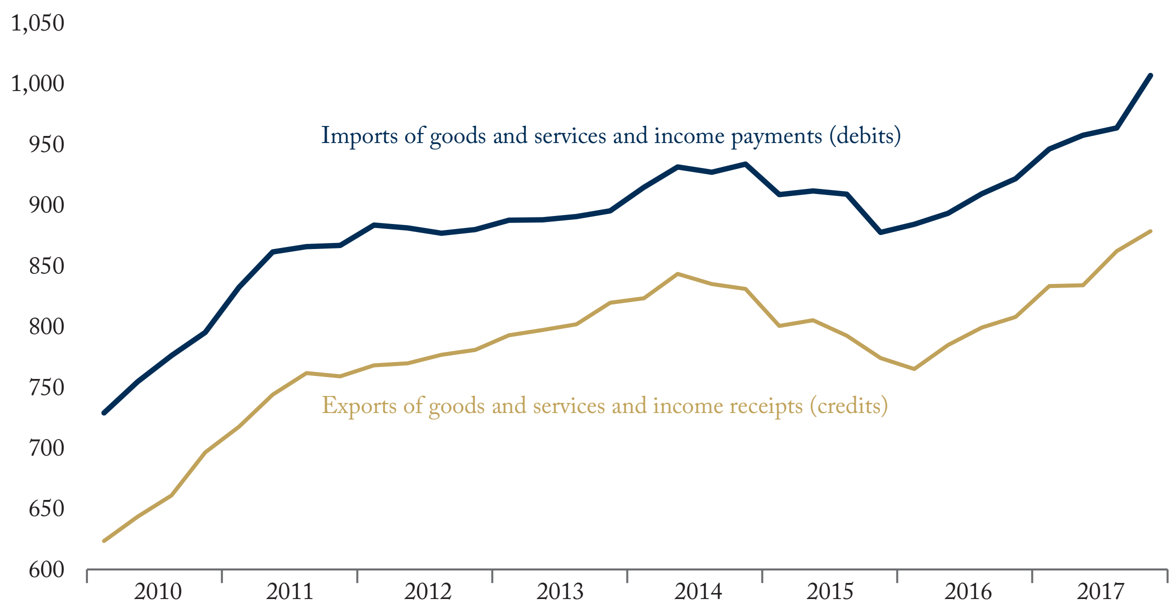
4 Conclusions

Should the world remain "cool" on faith that "it will all work out," as President Trump tweeted in commenting on the possibility of trade wars between the US and China? Should we be encouraged that the dialogue is shifting from import restrictions in the United States to export promotions (as argued by Richard Baldwin, 2018)? While trade angst might

27 Pete (2018).

28 McLaughlin (2018).

Figure 1: US Current Account Transactions, 2010-2017



Source: US Bureau of Economic Analysis (n.d.).

be reduced by these statements and considerations, the weaponization of uncertainty by the Trump Administration to effect change in the United States' trade relationship with the world cannot be ignored.

The uncertainty remains heightened, because no safety catches have yet been put on the potential triggers for all-out trade wars. The imposition of Section 232 duties on steel and aluminium from Canada, Mexico and the EU on 2 June 2018 has resolved some of the uncertainty – albeit not in a positive way for world trade. But it has also opened up new sources of uncertainty. The US now faces new uncertainty about the countermeasures that these parties will adopt in retaliation for the steel tariffs as well as the risk of further escalation by the Trump Administration, which only apparently knows how to escalate. The expiry of the deadline for the exemption of NAFTA parties appears to have been due to the US insistence on one of the key weapons of uncertainty – the 5-year sunset clause. The outcome of US-China talks on a China import package following three rounds of shuttle "diplomacy" by US and Chinese trade officials remains thoroughly opaque, as is the implication of this for China's relations with its other WTO trading partners, should it move to appease US demands through preferential measures inconsistent with its WTO obligations. And there is more uncertainty to come: the assertion of extra-territorial reach by the United States of its renewed comprehensive sanctions on Iran following its unilateral withdrawal from the nuclear deal, which it signed with Britain, China, France, Germany, and Russia, has triggered a countermove by the European Union forbidding its companies to comply. Companies will be caught in the crossfire.

Trade costs have risen due to a ratcheting up of political risk; the economic welfare impacts are in the pipeline from reduced business confidence in the global commitment to the rules-based, liberal trading system that operates under the WTO. We may wind up paying the costs of this lost confidence for years – even if full-blown trade wars do not erupt. Trade wars are not good and the uncertainty their threat generates makes them impossible to win.

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