# Commentary on India's Economy and Society Series

# 4

## Protectionism: US Tariff Policy and India's Response

### PART I

Manmohan Agarwal

## Protectionism: US Tariff Policy and India's Response

### PART II

Sunandan Ghosh

CDS
Thiruvananthapuram

India's Economy and indeed its society has been undergoing a major change since the onset of economic reforms in 1991. Overall growth rate of the economy has increased, the economy is getting increasingly integrated with the rest of the world and public policies are now becoming very specific compared over arching framework policies of the pre-reform period. Over the past few years, a number of important policies have been enunciated, like for instance the policy on moving towards a cashless economy to evolving a common market in the country through the introduction of a Goods and Services Tax. Issues are becoming complex and the empirical basis difficult to decipher. For instance the use of payroll data to understand growth in employment, origin-destination passenger data from railways to understand internal migration, Goods and Services Tax Network data to understand interstate trade. Further, new technologies such as Artificial Intelligence, Robotics and Block Chain are likely to change how manufacturing and services are going to be organised. The series under the "Commentary on India's Economy and Society" is expected to demystify the debates that are currently taking place in the country so that it contributes to an informed conversation on these topics. The topics for discussion are chosen by individual members of the faculty, but they are all on issues that are current but continuing in nature. The pieces are well researched, engages itself sufficiently with the literature on the issue discussed and has been publicly presented in the form of a seminar at the Centre. In this way, the series complements our "Working Paper Series".

CDS welcomes comments on the papers in the series, and these may be directed to the individual authors.

COMMENTARY ON INDIA'S ECONOMY AND SOCIETY SERIES - 4

# PROTECTIONISM: US TARIFF POLICY AND INDIA'S RESPONSE

## PART I

**Manmohan Agarwal**

CENTRE FOR DEVELOPMENT STUDIES
(Under the aegis of Govt. of Kerala & Indian Council of Social Science Research)
Thiruvananthapuram, Kerala, India

December 2018

**ABSTRACT**

Ever since the great depression economists have been wary of increasing protection. The trend has been to reduce protection. It has been recognised that current account imbalances reflect macro policy and cannot be corrected by trade policy. Trade policy has mainly distributional consequences. Despite this, demand for protection rises in the US when the dollar appreciates because of the combination of monetary and fiscal policies adopted by the US authorities. The charge of unfair trade practices also arises when the US believes that its preeminent position in the world economy is being threatened. The government of India, faced by a large current account deficit and a depreciating rupee has raised import duties and liberalised external commercial borrowing. The higher tariffs will not lower the current account deficit. More short-term borrowing is unwise as large short term debts are often a precursor to a foreign exchange crisis.

**Keywords:** Balance of Payments, Trade Policy, Capital Liberalisation.

**JEL Classification**: F13, F41

## 1. Introduction

On the 26th of September 2018 the government of India (GOI) announced an increase in the basic duty on 19 items and on 11th October on communications equipment. This was in addition to the increases in customs duties announced during the budget in February 2108 which had raised duties on about a quarter of India's imports. On the 19th of September, the RBI announced a relaxation of conditions for external commercial borrowings. The minimum period was reduced from 3 years to 1 year, and the amount that could be borrowed was increased.

We examine here the international economic situation which made GOI undertook these policies. In this first part, I examine these policies from a macro perspective. In the second part, my colleague Sunandan Ghosh examines these policies from a micro perspective.

GOI's rationale was the increasing current account (CAD) which was putting immediate pressure on the rupee and a longer lasting problem posed by a high CAD. We first analyse the behaviour of the exchange rate both in the immediate past and over a longer period. We then examine the attitude of economists in general to trade protection. We argue that trade policy is not the appropriate response to current account deficits. The main effects of trade policy are distributional. Despite this, the US Government has often resorted to protection and we argue that this is because of the demand for protection arising from the particular combination of monetary and fiscal policies adopted by US authorities. We examine whether the US current account deficit is good for the US and for the Rest of the World (ROW). We then analyse whether the Indian response is the appropriate one before concluding with some final observations.

## 2. Behaviour of the Exchange Rate

These changes in policy were announced to shore up the value of the rupee. How had the rupee been faring? There has been a slow, steady depreciation since 1995 when the rupee was made convertible on the current account. Only in the period 2003-7, the rupee appreciated.

**Table 1: Value of Rupee Versus US dollar**

| Year | Value | Change in value (percent) |
|---|---|---|
| 1995 | 32.42 | 9.3 |
| 1996 | 35.43 | 2.5 |
| 1997 | 36.32 | 2.5 |
| 1998 | 41.27 | 13.6 |
| 1999 | 43.05 | 4.3 |
| 2000 | 44.94 | 4.4 |
| 2001 | 47.19 | 5.0 |
| 2002 | 48.60 | 3.0 |
| 2003 | 46.58 | -4.2 |
| 2004 | 45.32 | -2.7 |
| 2005 | 44.10 | -2.7 |
| 2006 | 45.31 | 2.7 |
| 2007 | 41.35 | -8.7 |
| 2008 | 43.50 | 5.2 |
| 2009 | 48.40 | 11.3 |
| 2010 | 45.73 | -5.5 |
| 2011 | 46.67 | 2.1 |
| 2012 | 53.44 | 14.5 |
| 2013 | 58.60 | 9.7 |
| 2014 | 61.03 | 4.2 |
| 2015 | 64.15 | 5.1 |
| 2016 | 67.20 | 4.7 |
| 2017 | 65.12 | -3.1 |
| Average | | 3.4 |

Source: Reserve Bank of India Handbook of Statistics on the Indian Economy accessed at https://www.rbi.org.in/Scripts/Annual Publications.aspx? head=Handbook% 20 of % 20 Statistics % 20 on % 20 Indian % 20 Economy

The average annual rate of depreciation has been 3.4 percent. Only for two years has the depreciation exceeded 10 percent. The average annual rate of increase of the consumer price index for industrial workers during this period was 6.7 percent. This has implied that India's real exchange rate has been appreciating during this period, and perhaps there was a need for correction.[1]

1 The annual average increase of the CPI in the US during this period was 2.2 percent.

Over the past year from October 2017 to October 2018 the change in the value of the rupee can be divided into two periods. From 22nd October to 31st December there was an average weekly appreciation of almost a quarter of a percent. Since the 7th of January 2018 to the 14th of October 2018, there was an average weekly depreciation of about .4 percent, or about 20 percent, higher than previous rates of depreciation but perhaps not catastrophically. We shall discuss below the likely effects of the policy changes.

**3. Economists and Protection**

Smoot Hawley is seared into the consciousness, if not of economists, at least of trade economists.[2] The tariff in the US was raised to over 60 percent, the second highest by only a small margin—the highest was in 1820. It triggered retaliation. For instance, the UK passed the Abnormal Importation Act in November 1931 and the Import Duties Act in February 1932 (Friedman 1974, p. 26). These shocks led to widespread effects. World trade declined by more than 50 percent within the first four years of the depression. Exports of both the US and the UK declined by 60 percent. Total imports of the US and imports of manufactures by the UK also declined by about 60 percent. Assuming independence between nominal income and tariffs, Madsen (2001) estimated that world trade contracted during the depression from 1929 to 1932 by 13% because of falling income, 8% because of discretionary tariff escalations, 7% because of the imposition of discretionary nontariff trade barriers, and 5% as a result of deflation-induced tariff increases. However, assuming dependence between nominal income and trade barriers, part of the deflation-induced tariff escalations can be attributed to the increasing tariffs. Allowing for the feedback effects, the contribution of the imposition of the discretionary trade barriers was about as important as the output decline in explaining the contraction in world trade.[3]

Policy makers throughout the 1930s sought to reverse the increase in protection and jumpstart exports and growth of GDP through the export multiplier. The US passed in 1934 the Reciprocal Trade Agreements Act under which the president was authorised to cut tariffs up to 50 percent if the partner country also reduced tariffs.[4] In1935 a conference was held to stabilise exchange rates and take other steps that would lead to a revival of the world economy. A major motivation for Keynes' thinking about the post-war economic system was based on his desire to reignite growth and employment through trade expansion. His rationale for the International Monetary Fund (IMF) was that the IMF would provide short term balance of payments financing to obviate the need for countries to resort to protectionist measures.[5] In the 1930s such financing had not been available, so countries facing current account or balance of payments deficits had to restrict trade in order to try to balance their accounts.

---

2 For a discussion of the Smoot-Hawley tariff and its effects see Irwin (1996).

3 Also see Irwin (1998) for an assessment of the effect of the tariffs on trade.

4 For a discussion of the Act see Hiscox (1999) and Irwin (1998).

5 See Keynes (1978a and 1978b).

Trade economists have since been very wary of any increase in protection. For instance, economists were critical of the voluntary export restrictions introduced by the US mainly in the 1980s and the use of ant-dumping duties as a protection device. Again when the 2008 global financial crisis (GFC) hit economists were worried that it might lead to increased protection. Some projects were started to keep track of increases in protection. But the existence of the WTO under which tariffs had been bound had forestalled any large increase in protection.[6]

## 4. Rise of Protectionism in the US

The US after championing free trade for many years has been the major employer of protectionist devices in recent years. This is because of the particular combination of monetary and fiscal policies adopted in the US, particularly during Republican administrations. Tax cuts and increased defence expenditures have pushed up budget deficits. To offset the inflationary impact of this deficit the Fed has followed a contractionary monetary policy, namely raised interest rates. Furthermore, capital inflows have increased to finance the budget deficit. Both these effects have resulted in an appreciation of the dollar which has reduced the competitiveness of US production leading to demands for protection, and the administration has supplied some of this demanded protection. Till now, however, this protection has been constrained by the trade agreements at the GATT/WTO which have bound tariffs so they could not be raised to a higher level. The US was particularly constrained as its existing tariffs were at the bound level so that they could not be raised. The US resorted to other measures.

During the 1980s under Reagan, the US administration reached voluntary export restrictions agreements with suppliers, particularly Japan. For instance, the Japanese government agreed to limit the number of cars that it would export to the US. The US also used measures such as anti-dumping and countervailing duties as well as safeguard protection.

Under Trump, the US has resorted to mainly increased tariffs without any of the justifications used during the Reagan years. A number of countries including Canada, the EU and China consider these tariffs contravene US commitments at the WTO and the WTO has set up dispute panels to consider the complaints by these countries.

Trade policy seems to be accompanied by a belief in the US that it has been taken advantage of in trade matters, a situation that Bhagwati (1999) has called the 'diminishing giant syndrome'. In the1980s and early 1990s, US trade and other policy official attacked Japan for its trade policies that they claimed resulted in Japan having large trade surpluses.[7] Today Trump criticises China and Chinese trade policy.[8] Of course, the Trump attack is much more wide-ranging, encompassing even countries with which the US has a surplus.

6. A country cannot raise tariff above the levels at which it has bound them at the GATT/WTO.

7. In a series of articles reprinted in Bhagwati (1999) he discusses the US Japan trade dispute.

8. In part, it seems to be part of an attempt to maintain US hegemony. In the earlier period Japan and Germany were supposed to be overtaking the US and now it is China. It is also interesting to note that in the earlier period both Germany and Japan were expected to overtake the US and both were running large surpluses, but only Japan was under fire.

## 5. Trade Policy has Mainly Distributional Effects

As noted above the expansionary fiscal policy and the contractionary monetary policy that is being adopted by the US will lead to capital flows to the US and an appreciation of the US dollar, and a widening trade deficit. The trade deficit is not the result of trade policy nor is it amenable to correction by trade policy. The deficit is a reflection of a macro imbalance, an imbalance between savings and investment or between income and expenditure.[9] The main effects of trade policy are distributional both internationally and domestically. Once the overall deficit is determined by macro policy, trade policy distributes this deficit among the different countries. For instance, trade restrictions on China will likely reduce the deficit with China but increase it with some other country(ies). Similarly when protection is increased in a country output of the import-competing industries in the country will go up, and at full employment, output and employment of exportable industries will go down.[10] There is another distributional effect. According to the famous Stolper-Samuelson theorem, protection will raise the rewards to the scarce factor and reduce the rewards to the abundant factor. So in the US context, increased protection will lead to wages going up and rates of profit coming down. Some people may consider this desirable as it will reverse the trends of the share of capital going up and that of labour going down and real wage rates being stagnant. Rising wage rate may, however, ignite fears of inflation and the Fed is likely to continue raising interest rates. Attacking the trade policy of other countries masks the domestic distributional effects.

## 6. Does the Current Account Deficit Matter

We discuss in this section whether the deficit matters to the US and the rest of the world (ROW). When discussing the effect of the deficit on the US, we must keep in mind that the US dollar is the international money. The US can buy goods and pay the rest of the world with pieces of paper (dollar bills, treasury bills or bonds), to paraphrase Lloyd-George. The rest of the world has to use resources to export in order to import. The US can use resources to fuel domestic consumption or investment or defence expenditure and use these pieces of paper to buy foreign goods. This is what De Gaulle called the ‘exorbitant privilege’.[11] The deficit is a reflection of the US consuming foreign goods without having to pay for them.

---

9. As Bhagwati (1999) notes balance of payments surpluses and deficits reflect macroeconomic features, not trade barriers.

10. A question that was asked at the seminar at CDS was that increasing tariffs on oil would have no effect as the demand for oil had zero elasticity. This is a fundamental misunderstanding that the deficit being the result of macro forces would be unaffected irrespective of the elasticity of demand for oil. Suppose the demand for oil was very elastic then expenditures on oil would decrease. If this was saved then the savings investment balance would improve and the CAD decrease. But if the money not spent on oil was not saved but spent on other goods there would be no effect on the CAD. It could be spent on other imports so that the total import bill and the CAD would not change. It could be spent on goods that were being exported so that exports would also decline and there would be no change in the CAD.

11. The French have a long history of opposition to a reserve currency having this privilege. It was a feature of negotiations in the inter-war period as well as during the Bretton Woods negotiations.

Does the accumulation of dollars pose a problem to the US? No. The rate of interest the US pays on its liabilities is lower than what it earns on its assets. In other words, like any bank, the US pays a lower interest rate on its deposits and can invest it at a higher interest rate. So it earns an interest differential as long as other countries are willing to hold dollars.

Do the foreign exchange reserves held by other countries, particularly China, make the US vulnerable?

Let us analyse what would happen if China sells some of its reserves. The value of the dollar would drop. It might help the US deficit. But apart from that, it doesn't affect the US. Some other country would buy the dollars. It is not as in the Bretton Woods system under which the Chinese could demand gold from the US. This option is no longer available. So the Triffin problem does not arise, and the US doesn't have to do anything.[12] The Chinese would face the problem what to buy with the dollars that they are selling. Should they buy euros? But then how are they better? Should they buy US assets? That would have to be done judiciously. The Japanese bought many US assets in the 1980s. But a number of them including the Rockefeller Center turned out to be poor purchases.

Can the rest of the world refuse to accept dollars? What would they want to be paid in?

Can the US trade deficit be eliminated? Growth of the world economy and world trade requires increase in international money. Dollar is the international money. The only way the ROW can get dollars is by running surpluses, namely the US running deficits. If the US does not run deficits, there will be a shortage of international money, and the world economy could go into a recession. The world would need another money, if it is not willing to accept dollars. The world has tried that before, the Special Drawing Rights (SDRs)[13]. But the US has blocked attempts to make the SDR more important.[14] For the SDR to become an accepted international money, major countries would need to accept that. If the US really wants to eliminate its deficit it would have to agree to end the role of the dollar as an international money and agree to have another international money. It was because of the necessity for the reserve money to run deficits that the Germans and the Japanese did not want their currencies to become reserve currencies.

## 7. Effect on the World

### *i) Effect of Increased US Protection*

The effect on the world will depend on what the world decides to do. Other countries could retaliate. In that case, we would have a trade war, and we would be back to the situation that had prevailed in

12 The Triffin problem was that when countries had accumulated large dollar reserves they would try to convert them into gold and the US would not have sufficient gold sparking a crisis. Under the Bretton Woods system countries could demand gold for dollars. But since the Nixon decision of 1971 this is no longer the case. The US is not obligated to convert dollars into gold.

13 These were issued by the IMF to countries when the IMF believed that a shortage of foreign exchange reserves might arise. A country could use the SDRs to pay other countries with which it had a deficit.

14. Such a major change in the international system requires more than 85% of votes and the US with 17% can block any such attempt.

the 1930s, falls in world trade and incomes. This would seriously dent India's exports and income. Suppose the rest of the world does not retaliate. This seems to be the scenario at the moment. Countries except for China have retaliated very little and are trying to negotiate with the US. These negotiations would do little to rectify the US trade balance. But what it might do is to improve the terms of trade (TOT) of the US. The US is using its monopoly power to improve its TOT. This would increase the income of the US at the expense of the rest of the world, which would further worsen the US current account deficit.

***ii) Effect of the Fiscal-monetary Policy Combination in the US***

Normally, contractionary monetary policy would affect other countries through the real and financial channels. In the real channel, the lower GDP in the US following the contractionary policy would lead to lower exports, smaller current account deficits and appreciation of the exchange rate. The monetary channel effect would be that higher interest rates in the US would lead to an appreciation in the US dollar and both higher exports and higher interest rates in partner countries.

We expect the most likely scenario is that monetary and fiscal policies will cancel their effects on the GDP, one would be expansionary and the other contractionary. Consequently, the real channel would have little effect and the monetary channel would predominate. But tighter monetary policy would also have a direct effect through capital flows. It would force contractionary monetary policy in the other advanced countries among which capital flows are relatively free. So economic activity in these countries would decline leading to a second round of cutbacks in their imports.

What about developing countries. Most developing countries do not have significant portfolio capital flows. So, since income in the US would not change and their exchange rates would not be affected, there would be little effect on their economies. But their export would be adversely affected by the decline in economic activity in the other advanced countries.

India, unlike other developing countries, receives substantial portfolio flows, and so behaves more like the developed countries. India would face higher interest rates and additional depreciation pressures (Agarwal and Essid, 2015). The higher interest rates would slow down investment and so growth. The depreciation of the rupee would mitigate the adverse effects of slower growth in the other developed countries so that exports might not decline by very much. There would thus be little change in the current account and a worsening of the capital account.

## 8. Response of Indian Policy Makers

We have seen the response of Indian policy makers, increasing protection and liberalising capital inflows. India's past experience has been that tightening import restrictions does not solve deficit problems. That is why, following the liberalisation in 1991, the Indian government liberalised the exchange rate so that it might play the major role in managing the CAD. The deficit is a result of

excess demand and not trade policy. But there is a deeper problem with the policy of protection. India seeks to play a larger role on the world stage. But protection hurts the exports of other countries and will hinder the efforts to play such a larger role. In particular, India seeks to counter China in East and South-east Asia. The Indian government has proclaimed that their aim is to reduce protection in India to ASEAN levels. These countries are export dependent and are already unhappy as they believe Indian policy is too protectionist. The increases in tariffs create uncertainties about the direction of Indian trade policy and would drive a cleavage in relations between India and these countries.

What about the liberalisation of capital inflows?

It would lead to an increase in short-term foreign liabilities. A large increase in these is often the precursor to an exchange crisis. Very few countries have a larger short-term debt to reserve ratio than India. Most of these are Former Soviet Union republics, or Central America and Caribbean countries or countries in domestic turmoil. The only significant countries with a larger short-term debt to reserve ratio are Argentina, Tunisia, Turkey, Malaysia and Sri Lanka. All except Malaysia face significant current account problems.

We also find that if we look at the short-term debt to reserve ratio of the non developed countries of the G20 India's position has been worsening. We find that all the countries improved their position before 2007, short-term debt rose more slowly than reserves, all the ratios are less than one (Table 2). But in the period after 2007, the position of a majority of the countries deteriorated, ratio is greater than 1. Argentina has had to approach the IMF for assistance. Turkey is also in considerable foreign exchange trouble with the currency depreciating precipitously.

India's position is worse than what is depicted in the Table as it does not include NRI deposits as these are of more than one-year maturity. However, they pose two problems. One, deposits could be broken. But more significantly inflows of these deposits are important and a cessation of these inflows would create problems.

The recent liberalisation might solve a short-term problem but could lay the ground for severe problems in the future. Large commercial borrowings by companies render them vulnerable to large depreciations.

In summary, the Indian position in the world economy is fragile, and the measures that have been taken are likely to make the situation worse.

**Table 2: Short-term debt to reserve ratio (per cent)**

| | 1997 | 2007 | 2016 | 2007/1997 | 2016/2007 |
|---|---|---|---|---|---|
| Argentina | 143 | 42 | 123 | .3 | 2.9 |
| Brazil | 67 | 27 | 16 | .3 | .6 |
| China | 22 | 13 | 26 | .6 | 2 |
| India | 18 | 13 | 32 | .7 | 1.8 |
| Indonesia | 188 | 33 | 36 | .2 | 1.1 |
| Mexico | 97 | 31 | 30 | .3 | 1.0 |
| Russia | 34 | 21 | 12 | .6 | .6 |
| South Africa | 183 | 73 | 63 | .4 | .9 |
| Turkey | 91 | 56 | 92 | .6 | 1.6 |

## 9. Conclusions

Economists have been wary of trade protection ever since the steep rise in protection during the great depression. Studies show that this rise in protection reduced exports and worsened the decline in GDP in the countries. Policy makers have sought to reverse this rise in protection in the expectation that reduced protection would raise exports and so output and employment. Ever since Alexander's pioneering articles in the early 1950's it has been recognised that current account deficits are a reflection of macro imbalances and cannot be corrected by trade policy. Trade policy has mainly distributional consequences. It redistributes the deficit among the different suppliers of US imports. Domestically it shifts resources from exporting industries to import-competing industries and from the abundant factor to the scarce factor; in the US this shift in income would be from capital to labour.

Despite the limitations of trade policy in tackling trade deficits the demand periodically rises in the US for increased protection. This demand arises in the US because of the particular combination of monetary and fiscal policies that have been adopted under mainly Republican administrations. Budget deficits have increased because of tax cuts and increases in defence expenditures. The Fed has raised interest rates to limit the inflationary pressures rising from budget deficits. Capital inflows have increased in response to the higher interest rates and to finance the budget deficits. These inflows have led to appreciation of the dollar making many US companies and industries non-competitive and these industries have clamoured for protection.

In addition, the US has believed that its world leadership was slipping. In the 1980s and 1990s the challenger was supposed to be Japan, and now it is China. The slipping leadership is ascribed to unfair practices in these countries, and an attempt is made to browbeat these countries to change their policies.

Since the combination of fiscal and monetary policies is aimed at restricting any growth of incomes beyond the full employment level there should not be any effect on GDP and imports. The main effect would be higher interest rates. These would attract capital to the US. India is one of the few developing countries where portfolio flows are important and so there is likely to be a capital outflow. So the likely outcome for India from US policies is not very much change in the current account and a worsening of the capital account.

The government, concerned about the rising current account deficit and the depreciation of the rupee has increased import duties and liberalised external commercial borrowings. The increase in import duties is not going to change the current account deficit. It also flies in the face of the government's act east policy and their past statements that they seek to bring tariff rates down to ASEAN levels. The policy will be ineffective in tackling the deficit and worsen relations with East Asia.

The loosening of restrictions on short-term borrowing is also unwise. Large short-term debts have often been a precursor to a foreign exchange crisis. As it is, many countries have been increasing the ratio of their foreign exchange reserves to short-terms debt ratios since the Asian crisis of 1997. India had also increased this ratio between 1997 and 2007, though less than all the other large developing countries who are members of the G20. Since 2007 India's reserve position has worsened considerably. Steps need to be taken to reduce the short-term debt to reserve ratio rather than encouraging more short-term debt.

**References**

Agarwal Manmohan and Badye Essid. 2015. 'The Effect of US Monetary Policy on G20 Developing Countries,' in Manmohan Agarwal and John Whalley (eds.*) Asia and the World Economy Vol 2. India and China: Comparative Experience and Prospects*, World Scientific, Singapore.

Bhagwati J. 1999. A Stream of Windows, Unsettling Reflections on Trade, Immigration and Democracy, OUP, India.

Friedman Philip. 1974. The Impact of Trade Destruction on National Income, Gainsville, The University of Florida Presses.

Hiscox Michael J. 1999. The Magic Bullet? Trade Liberalization, Industrial Organisation 53 (4) p. 669-98.

Irwin D.A. 1996. The Smoot Hawley Tariff: A Quantitative Assessment, NBERWorking Paper No. 5509, NBER, Cambridge Mass.

Irwin D.A. 1998. 'From Smoot-Hawley to Reciprocal Trade Agreements: Changing the Course of US Trade Policy in the 1930s,' in Michael Bordo, Claudia Goldin and Eugene White (eds.) *The Defining Moment: The Great Depression and the American Economy in the Twentieth Century*, University of Chicago Press.

Keynes, JM (1978a) The Collected Writings of John Maynard Keynes: Volume 25 Activities 1940- 44 : Shaping the Post War World: The Clearing Union, The Royal Economic Society.

Keynes, JM (1978b) The Collected Writings of John Maynard Keynes: Volume 26 Activities 1941- 46 : Shaping the Post War World: Bretton Woods and Reparations, The Royal Economic Society.

Madsen J.B. 2001. 'Trade Barriers and the Collapse of World Trade During the Great Depression,' *Southern Economic Journal* 67 (4) p 848-868.

***Manmohan Agarwal** is RBI Professor at Centre for Development Studies, Trivandrum. His current areas of interest include history of the international monetary system, implications of establishment of the New Development Bank and on topics such as analysis of structural change in the Indian Economy and performance of the Indian Manufacturing sector.*

*Email: manmohan@cds.ac.in*

COMMENTARY ON INDIA'S ECONOMY AND SOCIETY SERIES - 4

# PROTECTIONISM: US TARIFF POLICY AND INDIA'S RESPONSE

## PART II


**Sunandan Ghosh**

**CENTRE FOR DEVELOPMENT STUDIES**

(Under the aegis of Govt. of Kerala & Indian Council of Social Science Research)

Thiruvananthapuram, Kerala, India

December 2018

## ABSTRACT

The US government imposed significant tariffs on its imports from China in 2018. China retaliated by slapping tariffs on its imports from the US leading to a trade war. This commentary looks into the various aspects of the US-China trade war. We first try to analyze the trade war itself and its causes followed by some immediate reactions and opinions. We also discuss the possible impacts of the US-China trade war on India. Finally, we analyze aggregate bilateral trade data between China, USA and India separately to analyze the immediate outcomes of the trade war on USA, China and India.

**Keywords:** Tariffs, Trade War, Trade Balance

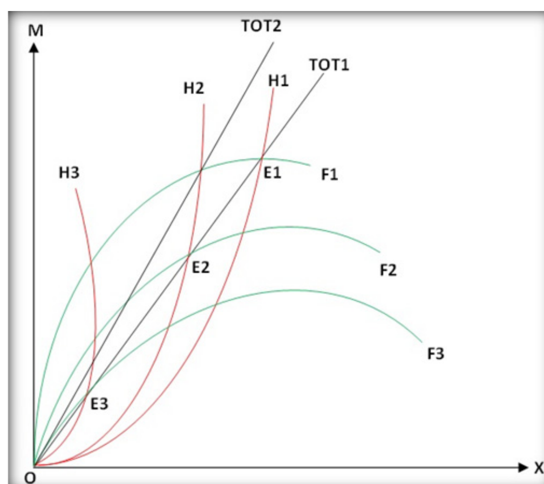
**JEL Classification**: F13,O24

# Protectionism: US Tariff Policy and India's Response (Part II)

## 1. What is a Tariff War?

Economic theory on protection postulates that a large country (one that can affect world prices) would impose tariffs on imports from its trade partner to maximize its national welfare[1]. The source of improvement in national welfare is improvement of terms of trade for the tariff-imposing country. However, this gain in national welfare of the tariff-imposing country comes with a more than offsetting reduction in national welfare of its trading partner. As a result, the country on whose exports tariffs are being imposed, would impose tariffs in turn to restore the terms of trade. In the process, volume of trade between these countries would diminish[2]. This is what we call trade war. Trade war can be illustrated graphically following the offer curve approach (Figure 1).

**Figure 1: Trade War (Offer Curve Approach)**




Let's assume the home country (H) imposes tariff one its imports from foreign (F). Then, Home's initial offer curve (H1) shifts to H2 and the terms of trade moves in favour of Home from TOT1 to TOT2. Then, Foreign would also impose tariff on its imports from Home and the foreign

1 See, for instance, Caves et al (2002) for a detailed analysis.

2 See De Scitovszky (1942) for a detailed exposition.

offer curve shifts from F1 to F2 and hence, the initial equilibrium E1 would shift to the new equilibrium E2. Further tariff slapping by these countries would lead to further reduction of trade (E3). Continuous trade war of this sort would culminate in no trade (imposition of prohibitive tariffs by both the countries) between Home and Foreign.

## 2. What is the "US-China Trade War"?

It started with the US government under President Donald Trump imposing 30% tariff on imported solar panels and 20% tariff on the first 1.2 million units of washing machines imported from China on January 23, 2018. On 6th July, 2018, the US government imposed sweeping tariffs on goods worth $34 billion imported from China. Tariffs were slapped particularly on aircraft parts, flat-screen televisions, and medical devices. These tariffs are 25% more than those existed. In retaliation, China imposed tariffs of 25% on US goods worth an equivalent $34 billion, including soybean, automobiles, and marine products such as lobsters. President Trump further declared that the US government would slap tariffs on additional imports from China worth US$ 16 billion and the total value of imports on which tariff would be imposed may culminate at US$ 550 billion (the United States' total import from China stood at US$ 506 billion in 2017-18)[3]. This process of tariff retaliation has continued resulting in what the popular press has coined as the "US-China Trade War".

## 3. Logic behind US-China Trade War

There can be multiple reasons to why President Trump initiated this trade war. The reason put forward by the US government was the burgeoning trade deficit US was having with China. However, imposition of tariffs is not a unilateral strategy. In fact, even a common man without much understanding of economic theory, can understand that China, being a large country itself, would retaliate if tariffs are being imposed on its exports, resulting in Chinese goods becoming less competitive in the US market. Hence, slapping tariffs to reduce trade deficit does not seem to be a very convincing reason to initiate such a trade war. It would only result in the Scitovszky type scenario explained in the first section.

One plausible reason for this action on the part of President Trump lies in the analysis of trade and wage-gap in the US by Krugman (2000).

> "*… an expansion of world trade, and especially of manufacturers' exports from low-wage countries, has coincided with a fall in the real wages of less-skilled American workers (and with rising unemployment in other advanced countries). It is natural to suspect a link between trade and declining wages; indeed, many commentators, including some economists, have not hesitated to assert flatly that growing trade is the principal cause of wage decline.*" (Krugman, 2000, pp. 52)

3 See the Economic Times dated 6th July, 2018 and the Indian Express dated 9th July, 2018 for detailed reports.

If we assume that US has a larger endowment of skilled labour (as compared to China), the US would end up importing unskilled intensive manufacturing goods from China. This would lead to a fall in the prices of unskilled intensive goods in the US market leading to a fall in real wages of American unskilled workers. Imposing tariffs on imports from China would reverse this process and protect the unskilled US labour force. This also satisfies President Trump's political agenda.

Along with ballooning imports from China, one more thing may have contributed to the widening skilled-unskilled wage gap in the US – skill-biased technological progress. However, the US government has made concerted efforts to favour skill-biased technology improvement in the US and not allowing China to acquire improved technology.

> "*President Trump plans to ratchet commercial tensions higher by barring many Chinese companies from investing in US technology firms, and by blocking additional technology exports to Beijing*". "*The twin initiatives are designed to prevent Beijing from moving ahead with plans outlined in its 'Made in China 2025' report to become a global leader in 10 broad areas of technology, including information technology, aerospace, electric vehicles and biotechnology. This is reflected in 90% plunge in Chinese investments in the US in the first five months of 2018 as compared to the previous year*" (the Times of India, 25th June, 2018).

Thus a mix of economic and political motives may have led the US government to start this trade war.

**4. Some Immediate Responses and Opinions**

US imposition of tariffs on steel and aluminium was severely criticized by Canada and the European Union because the distortionary effects of US trade policy on core sectors like steel and aluminium would adversely affect all major trading countries in the present day globalized world. At a micro scale, US multinational firms who have a presence in China may bear the brunt. Firms like Apple Inc., Walmart Inc. and General Motors Co., who have operations based in China, may face hurdles in the coming days from the Chinese government. Further, Chinese stocks reacted negatively with the trade war looming at large. With the news of USA imposing tariffs on China's exports to USA some economists shared their concerns as to the possibilities and extent of damage that may follow –

> "*China is an authoritarian dictatorship and is potentially able to play much, much dirtier than the United States. American manufacturers like automakers have made considerable investments into manufacturing facilities in China, and the financial and professional services sectors have a large and profitable presence there. These and other multinationals operating in China are vulnerable to a wide array of actions the government could take against them*" (Jacob Kirkegaard, Senior Fellow at the Peterson Institute for International Economics, as quoted in Maritime First, 20th June, 2018).

> "*Financial companies, along with legal, consulting, and other professional service providers could also find themselves facing more hurdles. The biggest fear is the inability for companies that make profits to repatriate their dividends as easily as they want to*" (Ludovic Subran, Chief Economist, Allianz and Euler Hermes, as quoted in Maritime First, 20th June, 2018).

Further, China hinted at larger trade with the European Union in the wake of US's tariff policy.

> *China told France on Monday it would buy more of its farm produce, hinted at future Airbus purchases and pledged to work on market access, shoring up its trade ties with Europe amid the increasing danger of a tariff war with the United States. Both China and the European Union are locked in their own trade disputes with the United States, and China has been seeking common ground with the EU in opposing what Beijing sees as U.S. protectionism* (Business Standard, 25th June, 2018).

Another question that was raised immediately was whether the US would gain from this trade war. In particular, what does this mean for the supporters of President Trump?

> "*If the U.S. adopts metal tariffs and China puts a tariff on U.S. cars. Instantly, U.S. cars are 30 percent to 50 percent higher in price in China, which loses a huge amount of market share for U.S. cars in China. Who will suffer? U.S. citizens, U.S. jobs, U.S. companies and the U.S. economy. By the way, China is both the largest and the fastest-growing car market on the planet*" (The San Diego Union- Tribune, 25th June, 2018).

**5. Where is India in all these?**

There were two diametrically opposite views circulating in the popular press/ media regarding the impact that this trade war would have on India. The first hypothesis predicts adverse impact of US-China trade war on India's trade through international trade linkages. The proponents of this view claim that China's loss of trade due to US tariffs would result in a chain reaction and trade between all nations would decline.

> "*This could trigger a reduction in global trade. The EU, India, China and other nations will not raise tariff barriers against each other. But if China sells less to the US, it will buy less from the EU, and the EU will buy less from India, which in turn will buy less from China*" (Scroll.in, 9th July, 2018).

The second hypothesis, on the other hand, predicts that India would benefit from the trade war. This view claims that India might pitch into the gap created by the trade war by trading more with the US and China bilaterally.

> "*By virtue of not being in the headlines, India likely benefitted. It is a large, fast-growing economy and could be seen as an alternative destination for investors concerned about a trade-*

*related slowdown in China*" (Derrick Irwin, senior portfolio manager at Wells Fargo Asset Management as quoted in the Economic Times, 29th June, 2018).

## 6. Trade Data Analyses

In this section, we look into the bilateral trade between (i) USA and China, (ii) USA and India and (iii) China and India using monthly data (aggregate). This we do in order to investigate the developments in bilateral trades in light of the various claims and opinions that we have discussed in the previous sections. We have used data from DGCI&S for India-USA and India-China monthly trade data for the period September, 2015 – August, 2018[4]. USA-China monthly trade data for the period October, 2015 – September, 2018 has been taken from US Census Bureau[5]. All figures used are in US$ million.

### *6.1. USA China Trade*

Figure 1 below illustrates US exports to China, US imports from China, US total trade (export plus imports) with China and USA's trade deficit with China. To start with, let's consider USA's trade deficit with China. US trade deficit with China dropped to US$ 25,874.6 million in March, 2018 from US$ 35,952.8 million in January, 2018 only to shoot up to US$ 40,243 million in September, 2018. In fact, this has been the maximum monthly trade deficit that US had over the period of analysis. Over the period of this analysis, US deficit from trade with China has grown at an average growth rate of 1.24%. The average monthly trade deficit that USA had with China for the period October, 2015 – June, 2018 is US$ 30,316.67 million while the average monthly trade deficit for the three months July-September, 2018 is US$ 38,548.97 million. This shows that imposing tariffs on Chinese goods has not been successful in reducing US deficit from trade with China, at least till September, 2018.

US import from China had declined to US$ 38,230 million in April, 2018 from US$ 45,788 million in January, 2018 only to peak at US$ 50,032 million in September, 2018. Over this period, US imports from China have grown at a small but positive growth rate of 0.68%. Interestingly, in a recent interview, Soren Skou, the CEO of A.P. Moller-Maersk A/S (world's largest container-shipping company) said that *"It's an ironic development… But after Trump has turned up the volume, the U.S. has only increased their imports from China even more"* (quoted in Bloomberg on 14th November, 2018).

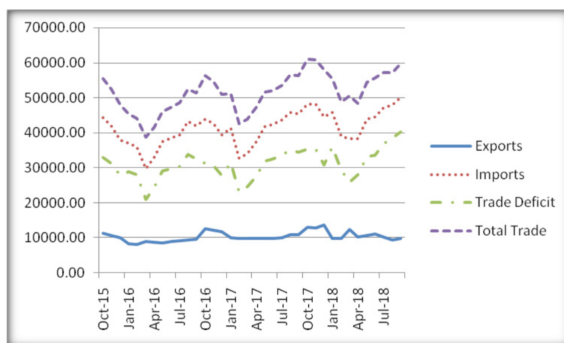
However, US exports to China reduced to US$ 9789 million in September, 2018 from US$ 12,382 million in March, 2018. US exports to China was growing at a rate (exponential fit) of 1% for the period October, 2015 – December, 2017 and fell at a rate of 2% during the period December, 2017 – September, 2018.

---

4 Accessed from http://commerce-app.gov.in/eidb/ on 13th November, 2018.

5 Accessed from https://www.census.gov/foreign-trade/balance/c5700.html on 13th November, 2018.

**Figure 1: US-China Trade**



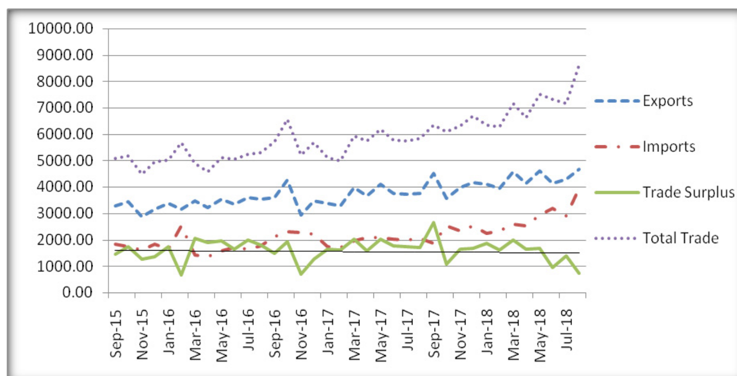

Thus, it would not be untrue to say that it is USA that has lost more in trade with China after slapping tariffs on Chinese goods. Soren Skou, in the same interview, claimed that "*Firstly, the U.S. economy is doing well, so consumers there have more money to spend on imports. Secondly, a lot of the really big U.S. companies are hoarding Chinese imports to buy as much as possible before tariffs kick in*."

However, it might so happen that US imports of particular commodities on which tariffs were increased might have gone down. But, imports of other goods have increased leading to an overall increase in total imports. Thus, one needs to perform commodity wise analyses of US imports from and exports to China to fully understand the impact of US tariffs on Chinese goods.

### *6.2. India-USA Trade*

Now we analyse the bilateral trade between India and USA to see whether India has gained (or lost) due to the US-China trade war. This we do because, as mentioned in Section 5, there have been conflicting views on what may happen to India due to this US-China trade war. Figure 2 provides India's exports to USA, India's imports from the US, India's total trade with USA and India's trade surplus with the US.

**Figure 2: US-India Trade**



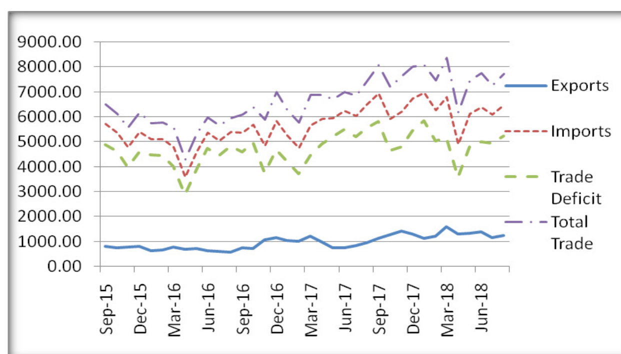
India's exports to the US jumped to US$ 4,574.81 million in March, 2018 from US$ 3,941.74 million in the previous month. India's exports to the US have increased at an average growth rate of 1.37% over the period September, 2015 – February, 2018 while the growth rate has been 3.37% over the period March, 2018 – August, 2018. Now, one may casually argue that this increased Indian exports to the US might be a reflection of the US-China trade war. However, we argue that such a proposition would be far from correct. This we say due to two core reasons. First, Indian manufacturing capability is far less from the Chinese and, presently, it is impossible to replace Chinese exports by Indian exports in the US market. Second, apart from the structural issues, there has been a sharp depreciation of the Indian Rupee (against US$) during this period. The Indian Rupee has depreciated substantially in 2018 (see Figure 4 in the appendix). In fact, the Rupee started depreciating against the US Dollar since February, 2018. Prior to that, since September 2015, the Rupee was, on an average, appreciating by 0.14%. Since, February, 2018, the Rupee has depreciated from 64.40 to 72.89 in August, 2018 at an average rate of 1.37% per month. Hence, the increase in India's exports to the US during March-August, 2018 is, most probably, due to any other reason including depreciation of the Rupee against US Dollar[6] but not due to the US-China trade war!

Over the period of this analysis, India's imports from the US have increased at an average rate of 3.6% plummeting to US$ 3933.84 million in August, 2018. This has resulted in the declining trade surplus that India has with the US since February, 2018 (5.64%). Now, increased imports and declining trade surplus do not fit well with a depreciating Rupee. It might so happen that the US is exporting more to India as it is facing higher tariffs in China. Hence, one needs to delve deeper to solve this puzzle.

### *6.3. India-China Trade*

We find nothing unusual in India's trade with China except for a sudden and temporary dip in India's imports from China in April, 2018 (Figure 4). Such a temporary dip might well be due to some cyclical fluctuations.

**Figure 3: China-India Trade**




6 Sinha Roy (2007) finds that disaggregated Indian manufacturing exports are responsive to own prices.

## 7. Concluding Remarks

Since President Trump imposed tariffs on Chinese goods, there have been numerous opinions and claims and predictions regarding not only US-China trade relations but India's trade prospects as well. In this commentary, we try to provide a brief overview of the USA-China trade war.

Using monthly bilateral trade data, we find that there has been no effect of President Trump's tariffs on Chinese goods on USA's imports from China at an aggregate level. In reality, US imports from China has increased over the last few months coupled with a declining US exports to China. We also find that India's trade with US has increased lately along with a sharp depreciation of the Indian Rupee against the US Dollar. We find nothing unusual in trade between India and China with India running a persistent and large trade deficit in trade with China.

However, analysis done in the present study is far from complete. A proper time series analysis of bilateral trade between USA and China has to be done using more time points, and one has to wait for that given the very recent nature of this trade war. Moreover, to analyse the nuances of this trade war one has to employ a commodity wise study of USA-China trade.

**References**

Bloomberg (14th November, 2018). "Maersk CEO Reveals 'Ironic' Twist in U.S. Trade War With China". https://www.bloomberg.com/news/articles/2018-11-18/battling-trump-s-250-billion-trade-war-one-company-at-a-time

Business Standard (25th June, 2018). "US Tariff Hike: The Hidden Side-effects of Donald Trump's Trade Wars". https://www.business-standard.com/article/specials/us-tariff-hike-the-hidden-side-effects-of-donald-trump-s-trade-wars-118062500937_1.html

Caves, RE, JA Frankel and RW Jones. 2002. *World Trade and Payments: An Introduction*. 9th Edition. Pearson Education.

De Scitovszky, T. 1942. 'A Reconsideration of the Theory of Tariffs,' *The Review of Economic Studies*, 9(2), 89-110.

Economic Times (29th June, 2018). "Trade war, China weary FIIs may find a Safe Haven in Indian Equity". https://economictimes.indiatimes.com/markets/stocks/news/trade-war-china-weary-fiis-may-find-a-safe-haven-in-indian-equity/articleshow/64787407.cms

Economic Times (6th July, 2018). "Trade War is On! Donald Trump Fires $34 bn Tariff Gun at China". https://economictimes.indiatimes.com/news/international/business/trade-war-threat-gets-real-as-trump-confirms-china-tariffs/articleshow/64877569.cms

Krugman, PA. 2000. 'Technology, Trade and Factor Prices,' *Journal of International Economics*, 50(1), 51-71.

Maritime First (20th June, 2018). "Trump Tariffs: Markets fall as Trade War Fears Mount". https://www.maritimefirstnewspaper.com/2018/06/20/trump-tariffs-markets-fall-as-trade-war-fears-mount/

Sinha Roy, S. 2007. Demand and Supply Factors in the Determination of India's Disaggregated Manufactured Exports: A Simultaneous Error-Correction Approach. *CDS Working Paper # 383*.

The Indian Express (9th July, 2018). "How Tariff War can hit all Trade". http://epaper.indianexpress.com/1729011/Delhi/July-09,-2018#page/12/1

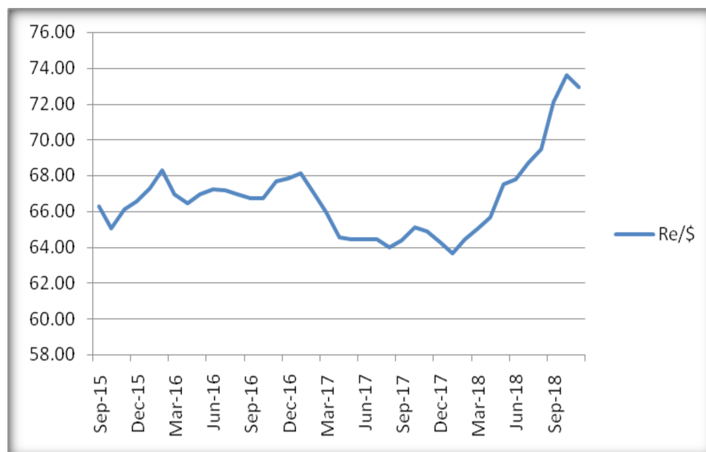
Times of India (25th June, 2018). "US Plans Curbs on Chinese Investment, Citing Security Risks". https://timesofindia.indiatimes.com/business/international-business/us-plans-curbs-on-chinese-investment-citing-security-risks/articleshow/64728845.cms

***Sunandan Ghosh** is an Assistant Professor at Centre for Development Studies, Trivandrum. His research interests include economics of integration, strategic trade theory, industrial organization and Indian economy. He has been working on theoretical issues related to enlargement decisions of trade blocs, parallel imports, product quality and empirical studies analyzing various aspects of the Indian economy.*

*Email: sunandan@cds.edu*

# APPENDIX

**Figure 4: Indian Rupee – US Dollar Exchange Rate**



## PREVIOUS PAPERS IN THE SERIES

1. **Dimensions of India's Economy:** ***As seen through the Economic Survey 2017-18 and the Union Budget 2018-19.***
   Manmohan Agarwal, Sunandan Ghosh, M Parameswaran, Ritika Jain, P Seenath, Hrushikesh Mallick, Vinoj Abraham, Udaya S Mishra, Sunil Mani, P L Beena. March 2018.
2. **Dimensions of India's Intellectual Property Right System. How Many Patents are Commercially Exploited in India?**
   Sunil Mani. May 2018.
3. **An Uncertain Shift from 'Protectionism' to 'Empowerment'? Probing the Decision by NORKA to Recruit Women Domestic Workers for Kuwait**
   Praveena Kodoth, November 2018.

**Centre for Development Studies**
(Under the aegis of Govt. of Kerala & Indian Council of Social Science Research)
Prasanth Nagar, Ulloor
Thiruvananthapuram 695 011
Kerala, India

Phone : 0471 - 2774200, 2448881, 2442481, 2448412
Fax: 0471 - 2447137
Website: www.cds.edu