

# International Trade and its Challenges

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Global trade affects every single member of 21st-century society, yet few understand its effects. Currently, several initiatives led by politicians aim to limit trade, particularly in the United States. While the presidential candidate Donald Trump has proposed a 60 percent tariff on all Chinese imports and a 10 percent tariff on all other imports (Wolf, 2024), the Biden-Harris administration has already increased the previous 25 percent tariff on Chinese EVs and some other goods to a substantial 100 percent (Dadush, 2024). Proponents of such policies often argue that countries with a trade deficit, which import more than they export, are being taken advantage of by other countries. The first section of this article will investigate this claim and explain the likely effects of a 10 percent tariff on imports. Secondly, in the face of supply chain disruptions and the war in Ukraine, the European Union and other countries have sought to reshore or friendshore certain industries for national and economic security reasons. This article will discuss whether and to what extent this can be a sound economic policy choice.

Figure 1 shows the balance of trade for the U.S. since 1990. There was a notable increase in the deficit

after the inception of NAFTA (North American Free Trade Agreement) in 1993, a free trade agreement abolishing tariffs on goods between the U.S., Mexico, and Canada. This agreement was updated in 2020 and is now called USMCA; the main difference is stronger labor protections (Chatzky, 2020). However, after the financial crisis, the deficit was lower and remained relatively stable, while the COVID crisis seems to have somewhat increased the deficit again.

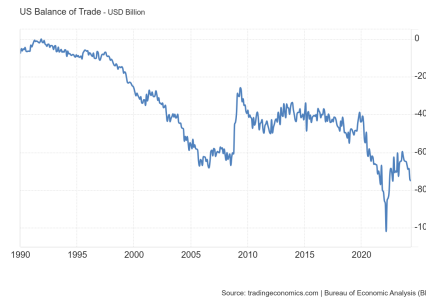


Figure 1: U.S. Trade Deficit in Billion USD

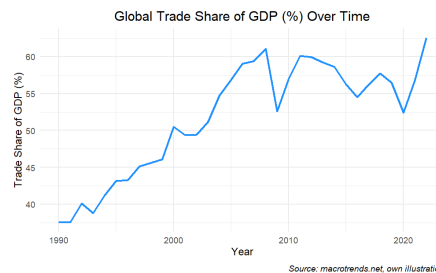


Figure 2: Global Trade Share of GDP

Figure 2 depicts the global trade-to-GDP ratio, which shows a very similar dynamic to the trade deficit of the U.S., as the trade share rose rapidly from 40 percent in 1990 to 60 percent by the financial crisis in 2008 since when it stagnated.

Trump and others blame NAFTA and free trade for job losses, particularly in the automotive and manufacturing sectors in the American Rust Belt. While this

is partially correct, it is estimated that only 5 percent of workers who were laid off due to rising imports from Mexico lost their jobs as a result of NAFTA. Furthermore, these job losses were compensated by jobs created due to rising U.S. exports to Mexico. While the trade deficit with Mexico increased, American exports to the country continued to grow, albeit not at the same high level (Knowledge at Wharton, 2016).

One possible reason for dissatisfaction with NAFTA is that while the job losses were primarily concentrated in the Rust Belt, the benefits — such as increased workforce productivity, a wider variety of goods and services, and lower prices for households — were distributed across the entire country and probably not attributed to NAFTA and free trade, but rather to ordinary economic growth (Knowledge at Wharton, 2016).

However, the overall effect of NAFTA is relatively small compared to what most people believe. As mentioned, about 5 percent of jobs lost due to higher Mexican imports were due to the trade pact. This shows that a large part of the considerable increase in trade between Mexico and the U.S. would most likely also have happened in the absence of the agreement. The fact that NAFTA contributed to about 400 USD of economic gain per person while per capita GDP was close to 50,000 USD emphasizes this point and shows why NAFTA is an easy scapegoat. While laid-off workers likely blame the trade agreement for losing their jobs, most Americans will not think of the 400 dollars they gained on average. It is also likely that many of these developments were merely accelerated by the increase in global trade, even in the absence of such trade agreements (Knowledge at Wharton, 2016).

It is logical that states would outsource parts of production to countries with lower costs due to lower wages, like Mexico, as this allows them to lower the product price, attracting more demand. In economic terms, Mexico has a competitive advantage over the U.S. in such sectors. As a result of the lower product prices, American consumers can afford to consume more.

The fact that the U.S. has a trade deficit is due to the high consumption of goods produced abroad, while the American economy is very advanced and primarily dominated by tech, finance, and other services. The American economy is simply too advanced to employ people to produce many ordinary goods, as the higher labor costs confer a competitive disadvantage on the country in such sectors. This is illustrated by the fact that the U.S. has a deficit in overall goods trade but a trade surplus in services (Statista, 2024).

The introduction of a 10 percent tariff on all imports would primarily increase costs for American consumers. An example of this is former President Trump's tariff on washing machines, which led to a price increase of 42 percent within five years. In the euro area, the price increase only amounted to 3 percent over the same period (Donovan, 2024). This price increase was possible as US washing machine producers could raise prices without losing market share in a less efficient market.

Most politicians with a basic grasp of economics are, of course, aware of this, unlike many voters. That is why many of these planned tariff increases will never materialize or will be small, aimed at gaining votes. While tariffs are economically harmful, these indirect effects are often hard to perceive and can thus make politicians more popular in affected areas (Wolf, 2024).

This fact highlights the importance of sharing the gains of increased trade with those who have lost their jobs due to it. Otherwise, this breeds discontent, which threatens trade and overall prosperity. A functioning social safety net and government-funded programs that can reskill individuals to adjust to new economic developments are crucial to ensuring shared prosperity and strengthening the fabric of society.

While free trade and offshoring can increase the efficiency of an economy, there are risks associated with this if the trading partners are not geopolitical allies or if the supply of critical goods is disrupted, as could be observed during the COVID-19 pandemic and the war in Ukraine. These events have led to renewed interest in reshoring and friendshoring certain economic sectors in both the U.S. and the EU.

In the short term, friendshoring — where countries realign their supply chains towards allied nations — could disrupt existing trade relationships, leading to a decline in global trade volumes. This strategy leads countries to source goods from less efficient producers within their network of allies, leading to increased production costs. Consequently, consumers could face higher prices for goods and services as companies pass on these additional costs. So, while friendshoring might secure supply chains against geopolitical risks, the economic cost may be prohibitive, depending on how big the cost difference between non-aligned and aligned countries is (Attinasi et al., 2023).

As shown in Figure 3, imports from China, the largest non-aligned trading partner, to the EU have increased since the financial crisis and now amount to almost 20 percent of imports. In the U.S., this figure stood at 16.5 percent in 2022 (U.S. Department of Commerce). This exemplifies how carefully



Figure 3: Share of Total Imports to EU from China

the reshoring of certain industries would have to be organized, as the EU and U.S. economies cannot lose 20 percent of their goods supply. Friendshoring must be done carefully and only in select industries, such as semiconductor chips, to satisfy the tradeoff between geopolitical risk and economic stability. However, particularly in the semiconductor industry, such reshoring has to be accompanied by significant diplomatic efforts, as China controls over 95 percent of the supply of germanium and gallium, which are crucial for producing semiconductors (Dempsey & White, 2024). China has already put some export restrictions on these materials (Dempsey & White, 2024), illustrating the complicated nature of establishing and supporting a semiconductor industry within more geopolitically aligned nations. It also further proves the impracticability of Trump's proposed 60 percent tariff on Chinese goods from a realpolitik viewpoint, as it would completely fragment global trade in a world of intertwined supply chains. Such fragmentation could reverse many of the gains from globalization that have driven economic growth over the past several decades (Attinasi et al., 2023).

In the long term, national economies might adapt to the new trade realities by fostering innovation and boosting productivity within new, friendshored trade networks. However, these adjustments will likely take a

long time and may not offset the initial economic shock, meaning that a breakdown in global trade likely would be marked by an economic slowdown and increased inflationary pressures (Attinasi et al., 2023).

Thus, policymakers must consider the complex economic landscape accompanying trade and supply chain realignment decisions. As countries consider friendshoring as a strategy to secure their supply chains, the economic costs and possible retaliation must be carefully considered and evaluated. The potential for higher production costs, reduced trade efficiency, and a decline in global GDP are significant risks that need to be managed. Therefore, such friendshoring should be constrained to critical industries in which offshoring poses a geopolitical risk. Supply chain instability due to the global spread of supply chains alone should not be a sufficient reason for reshoring trade, as the economic costs are prohibitive (Attinasi et al., 2023).

Overall, trade is a positive force, and whether a country has a trade surplus or deficit does not determine how much it gains from trade. However, global free markets open up competition and can result in job losses for certain segments of society. This issue must be addressed through publicly funded initiatives to share the gains from trade, as public support for trade depends on ensuring that negatively impacted individuals do not feel left behind. While trade increases wealth, there is a tradeoff between more trade and national and economic security in a world marked by geopolitical tensions. Although it is neither economically nor politically feasible to reshore all industries from non-aligned countries, producing critical goods, such as semiconductors, in aligned countries, is sensible. Otherwise, a country risks exposing itself to economic and national security vulnerabilities. A bal-

ance must be struck between ensuring this stability and protecting global trade, safeguarding the national economy.

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