COMMERCE & TRADE

The New Mercantilism's Old Mistake

Fear of China has revived the case for protectionism, which rests on a collectivist, instead of a liberal-individualist, view of trade.

PIERRE LEMIEUX

Large Chinese firms are generally more subsidized than their Western competitors (OECD 2026). In 2024, government subsidies (in proportion of revenues) for 15 key industrial sectors in China were three times higher than in North America and six times higher than in European OECD countries. Chinese subsidies averaged 3.1 percent of revenues across those sectors. In the estimates, subsidies can take the form of grants, income-tax concessions, or below-market loans to corporations whatever their private or government status.

In rich countries, there is growing concern that China's subsidies threaten their economies and national security. Those concerns are used to justify a trade war against China, especially in the United States and, increasingly, in Europe. Estimates invoked by the *Financial Times*'s editorial board suggest that the number of "new distinct subsidy state acts" in the United States now rivals China's, and both are being surpassed by the European Union (*Financial Times* 2026).

Reacting to foreign gifts of subsidized goods by forcing domestic taxpayers to finance similar gifts from their own countries underscores the self-defeating character of competitive subsidization: If every industry is equally subsidized, then no industry benefits, while taxpayers are harmed. Whether Chinese taxpayers will tire of this game sooner than taxpayers and producers in the free world (or what used to be called so), and which state will react more quickly to the resulting discontent, remains to be seen. Prudence suggests that states not interfere, except by setting an example, in the fiscal affairs of other states, including gift-giving activities—but Western politicians have not been so prudent.

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GIVING UP ON FREE TRADE

Many pundits and economic commentators in the West support retaliatory intervention and want more of it. *Financial Times* columnist Soumaya Keynes, to choose just one example, recently explained why she gave up on "the rules-based trading system." Against China, "you" will lose, she writes. First, "massive job dislocation" from imports entails a political risk of popular revolt. Second, a shriveled industrial base "could be harder to expand in a military emergency." Third, "the Chinese" are not interested in interdependence, and their dominance in certain economic sectors "could leave Europe vulnerable to coercion" (Keynes 2026b).

She has developed those ideas elsewhere (Keynes 2026a), including in a book with Chad Bown of the Peterson Institute for International Economics (Keynes & Bown 2026a, 2026b). They admit that the previous rule-based world order was preferable because free trade is beneficial, but they argue that defensive protectionism is now necessary.

The strategy they propose consists in identifying vulnerabilities caused by importers' supposed dependence on Chinese goods and addressing them with targeted restrictions on imports, subsidization of strategic materials (rare earth elements are the paradigmatic example), the accumulation of stockpiles, and export controls, notably of technological products. Naturally, theirs are good industrial policies, as opposed to—of course—the past and current bad policies (Lemieux 2026).

The new mercantilism / All this looks like a new mercantilism. Mercantilism was the 17th–18th century idea that control of foreign trade, together with domestic regulation, was necessary to dominate foreign states. Challenged by Adam Smith and other classical liberals of that era, mercantilism was the industrial policy of the time. But Smith and his fellow dissenters (rightfully) won the argument, and the demise of mercantilism propelled the Industrial Revolution and general prosperity in Europe and other countries that followed its model. The long self-isolation of China by its imperial governments (at times, private maritime commerce was forbidden), and later by its communist-Maoist regime, was also a sort of industrial policy that blocked its development (Scheidel 2019).

IMAGECHINA / ALAMY

Keynes is wise enough to admit that her plan is "grubby and there's a good chance it backfires spectacularly." We will see this chance is very high indeed. She underestimates two crucial factors: the efficiency of free markets compared to the Chinese sort of central planning, and the philosophical underpinnings of trade.

UNDERESTIMATING ECONOMIC FREEDOM

The fear that openness to international trade and economic freedom can compromise national security is much exaggerated. Keynes echoes the common argument that a strong industrial base is necessary in case of military conflict. One problem with this argument is that a reduction in international competition is likely to weaken the industrial base in terms of efficiency, which would matter in war. But that's not the only problem with this argument.

Virtually all production functions incorporate some substitutability of inputs. If an input becomes unavailable in wartime, some substitutes will likely be found—at a higher cost than before, for sure, but not an infinite cost. In 1943, American planes bombed a major German manufacturing center of ball bearings, which were used not only in engines but also in automatic rifles. German engineers developed substitutes. A later US government report found "no evidence that the attacks on the ball-bearing industry had any measurable effect on essential war production" (Lemieux 2024).

In the same vein, Keynes admits that the US government's stricter restrictions on exports to China with military potential—the so-called "China Military Catch-All Rule," implemented in 2007—spurred innovation in that country. But she seems to think that this time will be different.

In a war scenario with China, military supplies would normally be shared, at least partly, among allied countries on our side—and the more so if they are produced by private companies still benefiting from some economic freedom. For example, a few companies in America, Germany, and Japan are currently developing substitutes for rare earth elements in magnets (Douglas & Fukutome 2026). Keynes acknowledges this, but she doesn't seem to recognize that her sort of protectionist vigilantism risks dampening such cross-country cooperation.

A freer economy can be expected to be more flexible, innovative, and wealthier than a more planned and authoritarian one.

China shock / It is often claimed that a "China shock"—the wave of Chinese imports following its admission to the World Trade Organization (WTO) in 2001—resulted in deindustrialization in the United States and other developed countries. It is true that the proportion of workers occupied in manufacturing has typically continued to decrease over the past quarter-century, but that is due largely to technological and market-demand changes. Instead of factories teeming with blue-collar workers, manufacturing in the developed world has been increasingly done by robotic machines overseen and maintained by fewer (but better paid) tech and white-collar workers. Meanwhile, because of growing consumer demand for services (health, education, housing, etc.), the share of value added by manufacturing in GDP has typically decreased in Western countries. Yet, the real value added in manufacturing (equivalent to its actual contribution to GDP) has typically increased. Between 2001 and 2025, the real value added in manufacturing grew by 51 percent in the United States and 41 percent in the EU (despite a drop in Germany over the last few years).

A freer economy can be expected to be more flexible, innovative, and wealthier than a more planned and authoritarian one. Chinese history itself confirms this. Three centuries after the Industrial Revolution in the West, Chinese GDP per capita (in purchasing power parity) still does not reach a third of America's; in current dollars, the figure is 16 percent (all data from the World Bank). China grew rapidly after the death of Mao Zedong and its opening to foreign commerce, but it is still a developing country whose total production is huge because it has a huge population of relatively poor people. In 1997, the year when the territory of Hong Kong was handed over to the Chinese government, the GDP per capita (in PPP) of Hong Kong was much higher, at 85 percent of the US level.

The current problems of the Chinese economy (lower investment and returns, dependence of Chinese firms on government subsidies, lower retail sales, the long-running real estate crash, deflation fears, issues of data reliability) reflect the unavoidable weaknesses of a planned economy. Government-stimulated exports imply lower production elsewhere in that very economy. Regarding military ability, the Russian government has shown its inefficiency after attacking a much smaller but freer (or, at least, much less unfree) Ukraine. Governments of unfree countries are constantly trying to catch up with freer ones, always with a lag, and often by stealing technology and shamefully exploiting their populations—the extreme case being North Korea.

The "industrial base," in the narrow sense of dirty factories producing dumb hardware, has become relatively less important to national security. More important have become high-tech conception, electronic wizardry, and entrepreneurial inventiveness, not to mention the motivations of the defenders.

Pandora's box / Another of Keynes's arguments for accepting the trade-war logic is to prevent popular (or populist) revolts against economic shocks. For example, tariff revenues can assist the individuals affected by disruptions. But note that the higher and more protective of domestic industry tariffs are, the less money they raise because higher prices reduce the quantity demanded of imports.

More generally, the whole case for protectionism as a guardrail against populism overstates the role of the China shock relative to technological change. It is estimated that 1 million manufacturing jobs disappeared in the United States because of the China shock of 1999–2011. (We can get a maximum of 2.4 million jobs lost if we torture the data.) Over the same period, so many new jobs were created in other industries that the net number of jobs increased by more than 6 million.

Moreover, predictable foreign retaliation against domestic protectionism raises its own political risk at home. The mounting tone of retaliation threats from all quarters—America, China, and Europe—portends future domestic and international unrest. Mercantilism is a Pandora's box. Don't open it. Nearly three centuries ago, Montesquieu argued that international trade promotes "gentle mores" and international peace. An important economic literature supports this hypothesis. But some economists, including Keynes and Bown, think that the vulnerabilities created by interdependence are also likely to lead states to rivalry and war.

A very recent piece of econometric analysis supports a causal relation from international trade to peace (Feng et al. 2026). To avoid spurious correlation, the authors use what econometricians call an "instrument" for trade: air freight becoming less costly because of technological progress. Their analysis of data from 1962 to 2014 indicates that international trade "causally reduces both the likelihood and intensity of militarized disputes" as well as "the probability that countries perceive one another as strategic rivals." One plausible reason is that the benefits of trade increase the opportunity cost of war both for rulers, who want to prevent discontent from their subjects, and for the subjects themselves.

Public choice economics has put in sharp focus the fact that political and bureaucratic processes, led by ordinary individuals who are mainly self-interested, don't lead to the nirvana expected from an idealized state (Mueller 2003). Government failures are at least as bad as market failures. Voting can produce incoherent results as shown by the Condorcet paradox and its contemporary extensions (Riker 1982). Mercantilism is to corporate rent-seekers what a beehive is to bears. Many reports have highlighted the large growth in federal lobbying expenditures related to tariff requests or, from the side of importing businesses, to tariff-exemption pleas (Legistorm 2026). Politicians and bureaucrats are motivated to increase the size of the state. Europe is not immune to these government failures or to populist rulers.

The dependence argument / What of the concern about an importing country becoming dependent on a strategically rival country? Neglecting for now the dangerous ambiguity of the concepts of importing or rival countries or nations, the dependence concern is related to the industrial base concern and has similar flaws. The fear of dependence can too easily be used to hide the protectionist motives of rent-seekers and their lobbyists. Dependence scares can lead to conflicts and war. Specialization and the division of labor generate prosperity. This is why most Chinese and most Westerners—at least those not entangled in nationalist emotions—know that war between their states would impoverish them. And note that dependence on one's own state's permissions does not lead to nirvana.

On this issue of permissions, Keynes admits that "cumbersome EU regulation" has played a role in the success of Chinese exporters. Cumbersome regulation is not a market failure but a state failure. Except in fairy tales, it is unlikely to be solved by more government power and intervention. The head of ASML, the Dutch maker of the world's most advanced lithography machines (used in the manufacturing of semiconductor integrated circuits), recently raised the alarm about the danger of political authorities' intervening more directly in the development of high technology and international trade (Moens & Bounds 2026). Solving the real problem of stifling regulation is more important than whining about China.

Philosophical underpinnings / The sorts of argument Keynes offers are not only weak from a narrow economic viewpoint, they also have questionable philosophical underpinnings.

The *Financial Times* tells us under its editorial masthead that "since 1888, this newspaper has argued for free markets, free trade, and liberal democracy." If, by this ideal, they mean classical liberalism, this is not what its editorialists (and many of its columnists) coherently argue for. Their conception of a free society is swamped by exceptions. They recognized the risk of using "China's economic playbook" but, in the same breath, proposed defensive protectionism as an industrial policy—that is, a China-like playbook (*Financial Times* 2026, Lemieux 2026).

It is worth reflecting on the classical liberal values that justify a free society. The intrusion of normative values in our analysis is not surprising: 20th-century welfare economics showed that any policy recommendation ultimately rests on value judgments (Bator 1957).

TWO CONCEPTIONS OF TRADE

In the classical liberal tradition, a free society is a society where individuals are equally free. "We can all be free," wrote James Buchanan, one of the main contemporary theorists of classical liberalism (Buchanan 2006). Anthony de Jasay proposed a useful characterization of what a free society implies for the role of politics (if politics is unavoidable). He defined classical liberalism as "a broad presumption of deciding individually any matter whose structure lends itself, with roughly comparable convenience, to both individual and collective choice" (de Jasay 1989). Deciding individually encompasses the choices of private and voluntary groups of individuals such as corporations or other forms of association.

This opposition between, on one side, individual and private choices and, on the other, collective and political choices provides a useful criterion for evaluating political systems and ideologies. We may think of individualism as representing the primacy of individual and private choices, and of collectivism as the primacy of collective and political choices. "Collectivism," notes the *Encyclopedia Britannica*, "has found varying degrees of expression in the 20th century in such movements as socialism, communism, and fascism."

Many sorts of "conservatism" are also collectivist. At the polar opposite is individualism, which covers classical liberalism and libertarianism. Parallel to the distinction between individualism and collectivism stand two very different conceptions of trade.

Collectivist conception / International trade is often discussed in a manner that echoes the old collectivist approach of mercantilism. For collectivism, what matters is not the welfare of individuals but the welfare of the collective. Keynes complains that, vis-à-vis China, "you'll still lose" if you don't retaliate against "your opponent." But who is "you"? Certainly not the American consumer who buys furniture or toys from China, or the European consumer who is happily allowed to buy Chinese electric cars. For that matter, who is "China" or "the Chinese" or "your opponent"? Who is "Europe"? In the (even unconscious) collectivist approach to trade, these entities are assimilated to the collectives ruled by their respective governments.

These are only words, one might object. Grammatically, after all, collective nouns just represent groups of people. But when one does social theory or commentary, there is a danger of forgetting that a political collective is a group of individuals forced (in some way, or for some of those individuals) to act collectively by their government. In international trade as in any exchange, individuals are the ones who ultimately buy and sell, and all may do so freely to the extent that they live in a free society. By always hearing loose soundbites as if the collectives were the legitimate agents in international trade, one may end up thinking that "Europe" or "the United States" trades with "China."

Friedrich Hayek brought to our attention what he called "our poisoned language," biased toward primitive and tribal ways of looking at the world (Hayek 1988). Society is personified and everything "social" is glorified. The collectivist way of speaking about trade is an instance of this poisoned language. Scientifically, we can only understand the social world through methodological individualism—that is, by starting from the individual's motives and actions.

In the collectivist conception of trade, international trade happens—or doesn't—between "countries" or "nations." No individual or private group decides freely where to buy or sell outside of "national" borders, except under a special concession from the collective. Individual and private choices are always subject to collective or political choices.

Individualist conception / The individualist (or classical liberal or libertarian) conception of trade, internal or external, is very different. A voluntary exchange is beneficial for each voluntary party; if any of the parties did not expect a net benefit, the exchange would not happen. Individuals and private organizations take care of their own trade balances. What Keynes rightly calls "the violence of trade barriers" should be the rare exception, irrespective of whether other governments in the world coerce their own subjects or citizens. Let's be free even when foreigners are not.

An example may illustrate how free exchange in general is a necessary condition of a free society. Suppose a state—say, that of North Korea—coercively prevents its subjects from leaving to marry individuals who live in your country. Do you think your own state should retaliate and enact a "reciprocal" prohibition? Wouldn't that just be defensive protectionism? If the restrictions imposed on the liberty of its citizens or subjects by any state in the world were adopted by all other states, the entire world would be a uniformly hellish place.

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The exchange of goods or services is a similar—and simpler—case. A few centuries ago, economic theory refuted the false intuition that unilateral free trade, declared by the state of one country, would lead its inhabitants to import everything from abroad and buy nothing from home, thereby depriving themselves of the very employment and means necessary to import. David Ricardo's theory of comparative advantage provided the refutation: At the country level, like at the village or individual levels, the determinant of trade is *comparative* advantage. It is the domestic opportunity cost of producing at home instead of importing that matters on both sides. Individuals import goods and services that cost relatively more in terms of domestic resources in their country than they cost in foreign resources when produced abroad, and *mutatis mutandis* as viewed from the foreign country. An efficient use of resources is therefore achieved in each country (Krugman 2002).

Consequently, and despite possible adjustment costs (life is full of adjustment costs in pursuit of happiness), unilateral free trade, which is less beneficial than all-around free trade, is still preferable to partial or total autarky. In a world where there will always be unfree societies, any state can let its citizens reach a second-best by declaring unilateral free trade—that is, by letting them be free to import and export regardless of the trade policies of their trading partner's government. The British government did that in the mid-19th century. The administration of Hong Kong did it after World War II.

Before the start of the current American trade war in 2018, we can nearly say that many countries, including some rich countries, were *partially* unilateral free traders in the sense that their government-imposed tariffs ("applied tariffs") were lower than the maximum ("bound tariffs") allowed by WTO rules.

RULE-BASED WORLD TRADE

Many lament the demise of the previous "rule-based" world order under the WTO. Keynes is among them, but she apparently thinks that this world is gone and that only winning the trade war could (perhaps) bring it back.

That previous world, however, was a confused mix of the individualist and collectivist conceptions of trade. So-called free-trade agreements had increasingly become regulatory treaties, aiming at uniform regulations on labor and wages, the environment, or so-called dumping. Indeed, many of the recent trade agreements signed by the US government did not have "free trade" or even "trade" in their names. In 2018, the United States–Mexico–Canada Agreement was bullied into existence by Donald Trump as a replacement for the North American Free Trade Agreement (Lemieux 2018). The same president removed the American state from the 12-country Agreement for Trans-Pacific Partnership, whose name was thereafter prefixed by the politically correct "Comprehensive and Progressive," but still without "free trade" or even "trade."

Rules are, by definition, abstract and general; they are the opposite of ad hoc commands from some political ruler or rulers. Hayek reminded us that a self-contradictory rule is not a rule, at least not in the sense of the rule of law. "If a law gave the government unlimited power to act as it pleased," he wrote, "all its actions would be legal, but it would certainly not be under the rule of law" (Hayek 1960). The primacy of collective choices over individual choices is a perilous model.

Although Nobel economics laureate Paul Krugman has not been a consistent liberal-individualist, he once argued that free-trade agreements were sets of rules mutually designed to constrain one's own government against *domestic* rent-seekers (Krugman 1997). In this perspective, rule-based free-trade agreements could be seen as an approximation of—or second-best to—the ideal of all-around unilateral free trade. In this view, *foreign* negotiators work for domestic consumers by trying to prevent tariffs (which are a domestic tax) imposed by one's own domestic government.

Krugman is now among those who have given up on free trade, at least with Chinese exporters and importers, mainly—it seems—for reasons of national security. He has also become sympathetic to industrial policy, provided of course it's *good* policy, which in his case means favorable to the environment and unfavorable to China (Krugman 2025). Although a nuanced opinion is not a failing, it is difficult for a logical mind to entertain both an individualist conception of trade—as Krugman mostly did throughout his career—and simultaneously a general preference for collective choices, which he did—and still does—hold. A good theorist had to solve or dampen this cognitive dissonance, and Krugman may now be leaning collectivist in trade too. Of course, changing one's mind is not an intellectual sin per se; it depends on the reasons for doing so.

RESETTING THE PROBLEM

The security of a free country is a real problem, but the problem needs to be set up correctly. Why do "we" want national security? Presumably because a free society is worth preserving and reinforcing. Instead of viewing the world of exchange as a power struggle between the totalitarian and autocratic Chinese state in one corner and the American (or European) state in the other, we should try to see the individuals in Western countries and those in China attempting to trade together for their mutual benefits. Except for preaching by example and trading freely ourselves, we can do little for the hapless Chinese. But our governments should stop messing with us.

Adam Smith, it is true, thought that tariff retaliation could be justified if it was likely to bring the repeal of the targeted foreign tariffs, but he much more often emphasized the cost of domestic tariffs themselves. Smith also believed that national defense considerations could justify some barriers to international trade, but he would certainly not have favored adopting the very mercantilism he was arguing against. Moreover, we have learned new lessons in the last two and a half centuries.

One lesson is that constraining our own governments is fiendishly difficult. The *Financial Times* editorial quoted above did warn that "governments must guard against interventions expanding beyond … narrowly defined purposes." "Once governments accept a larger role in directing economic activity," they added, "boundaries become harder to maintain." That's a nice thought.

Similarly, and to exaggerate only a little, Keynes seems to argue that free trade is good, but we can't have it anymore, so we must try to win the trade war, even if nobody wins a trade war, and there's a good chance that this strategy "backfires spectacularly." So, let's do it anyway. If it doesn't work, our nice government will just try something else, within newly defined boundaries.

We must admit some limited exceptions to the individual freedom to trade. A (real) criminal in jail is rightly prevented from trading at will. It is difficult to argue for zero restrictions on trade with a member of an enemy collective during war. But some restrictions are less likely to defeat the purpose of defending a free society, such as preventively building up reserves of military supplies and restricting defense procurements.

Individual liberty must be the rule, authoritarian intervention the exception. Hayek persuasively argued that "freedom will prevail only if it is accepted as a general principle whose application to particular instances requires no justification."

He wrote:

> Since the value of freedom rests on the opportunities it provides for unforeseen and unpredictable actions, we will rarely know what we lose through a particular restriction of freedom.... And so, when we decide each issue solely on what appear to be its individual merits, we always over-estimate the advantages of central direction. (Hayek 1973)

Hayek himself recognized the need for *temporary* increased power to a liberal state in emergency situations. But he likely had in mind real emergencies like a raging or imminent war, not the existence of a dictator-ruled communist state that runs a total industrial policy, constrains its hapless subjects' entrepreneurship, and limits their freedom to trade.

***Whimsical governments* /** In a liberal-individualist conception of trade, it would be logically contradictory to give national security, or any protectionist excuse, primacy over free exchange between private parties. And we should not be surprised if, in their pursuit of defensive mercantilism, American and European political authorities pile up still more stifling regulations and interventions.

The danger of using authoritarianism against authoritarians is illustrated by recent events in the artificial intelligence (AI) industry. We don't know how AI will develop and what exactly its effects will be, but it is a safe bet that politicians and bureaucrats will not improve on the process and its outcomes. Chinese advances in AI "coincide with unprecedented U.S. government roadblocks to developers releasing models," observe McMillan et al. (2026). They quote Niels Provos, a researcher who led security teams at Google and Stripe, noting that whimsical US intervention "is incentivizing companies across the globe to use cheaper but very capable Chinese open-weight models, while at the same time undermining the U.S. AI industry." As venture capitalist Marc Andreessen has observed, "We're in a weird state of the world where the supposedly totalitarian regime is trying to open up the technology, and the supposedly democratic governance system is trying to restrict and control technology" (Hammond & Miller 2026).

The US government has lately failed quite badly at protecting its citizens' individual freedom to trade, not to mention setting an example of free society. The EU government and European states will not do better if they follow America's example of more collectivist trade. R

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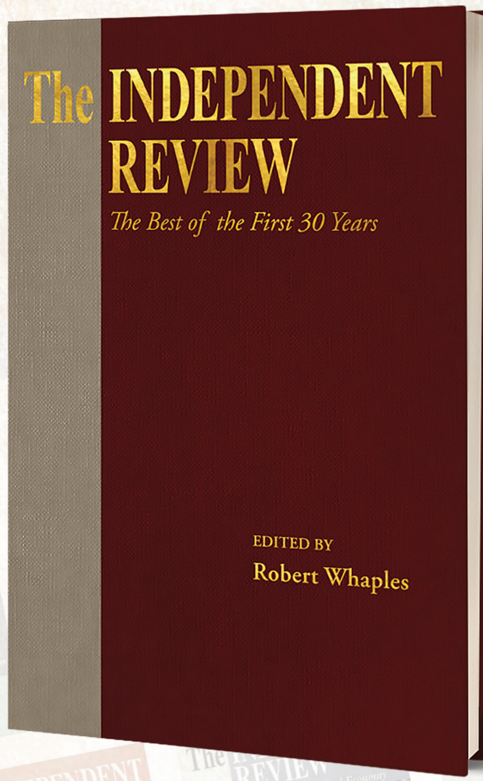

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