# Issue: Free Trade

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### Is its age of expansion at an end?

## Executive Summary

Is the era of trade liberalization that began in 1945 over? The collapse of world trade talks in 2008, Great Britain's shocking vote last year to leave the European Union and the election of President Trump on an anti-globalization platform suggest that it might be. The gains from trade for both advanced and emerging economies are hotly debated. While economic globalization lifted hundreds of millions from poverty, developing countries have balked at further trade talks dominated by rich nations. Workers in industrialized countries have begun to doubt that free trade is a net positive for them, and politicians have responded with an about-face on new agreements. For supporters of global economic integration, the way forward is unclear.

Among the key takeaways:

- World trade fell precipitously during the Great Recession of 2007–2009, and dropped again in 2015 by nearly 14 percent.
- A trade war—possibly sparked by new U.S. policies, followed by retaliatory tariffs by China and other trade partners—could result in massive job losses in the United States and elsewhere and trigger a recession.
- Further trade liberalization looks unlikely in the near term; merely maintaining current levels of integration may require new strategies and policies.

## Overview


The Trans-Pacific Partnership and other trade deals have sparked opposition in many nations, including Mexico, where this woman demonstrated in 2016. (Pedro Pardo/AFP/Getty Images)

Joe Del Signore Jr. runs a catering business in Johnstown, Pa., and has voted for Democrats his entire life. Until last November, that is, when the 60-year old pulled the lever for Donald Trump in the presidential election, because "we needed a change in the way the country was being run."

One of Del Signore's biggest concerns was jobs, especially those lost to deindustrialization in this part of Western Pennsylvania. "We lost thousands of jobs in the last 15 years in coal, steel and railroads," says Del Signore. "Free trade had gone too far. We were being taken advantage of in so many areas."

Del Signore's vote, along with those of more than 2.9 million other Pennsylvanians, handed the swing state and its 20 electoral votes to Trump, who campaigned on promises to upend U.S. trade and immigration policies.

Largely because of people like Del Signore, the growth of international free trade is at a potential inflection point, as voters in the United States and around the world turn against global integration and politicians follow their lead. The costs of a global trade contraction could be significant in terms of economic growth and geopolitical stability; yet a path forward even to maintain the current level of trade is difficult and may require more compromise and political courage than politicians can muster in the near term.

The depth of this challenge can be gauged on different levels: the hard data of trade flows and the more subjective attitudes of policy makers and their constituents.

Global trade expanded at a rapid pace for six decades following World War II. It was particularly brisk from 1985 to 2007, a period that "witnessed substantial globalization and rapid economic growth," when trade grew twice as fast as global gross domestic product (GDP), according to the International Monetary Fund. [1]

The Great Recession of 2007-2009 interrupted that trend and sent trade volumes plummeting. They recovered by 2011, but not robustly. The volume of world trade, both goods and services, has grown around 3 percent a year since 2012, less than half the average rate of the previous three decades. [2] The slowdown is largely due to weaker economic growth in advanced and emerging economies.

These figures concern many economists, who believe the growth of trade has significantly contributed to the overall welfare of people in advanced and emerging economies alike. [3]

But a thornier problem is now emerging for proponents of growing free trade. The appetite for economic integration—the free movement of people, investment or goods across borders—is waning in both poor and rich nations.

The former expressed their discontent about trade liberalization in the first decade of this century when they collectively put a halt to the latest round of World Trade Organization (WTO) negotiations, in the belief that rich countries were not treating them fairly. [4] The latter found their voice in recent anti-globalization votes in Great Britain and the United States, as well as the rise of anti-immigrant and anti-trade political parties in many European nations.

As a result, additional trade liberalization through the WTO is, for the moment at least, completely off the table. Free trade deals that have been in the works for years, including the Trans-Pacific Partnership (TPP) and the U.S.-EU Transatlantic Trade and Investment Partnership (TTIP), have been abandoned by the United States, which may ultimately doom them. Meanwhile, the pace of new treaties globally has slowed significantly, and existing ones, including the North American Free Trade Agreement (NAFTA), may be scaled back. Barriers to trade are suddenly being erected at an alarming pace, according to the WTO. [5] These developments portend not just a halt to greater levels of trade, but a possible contraction.

"At this point in time what we don't need is the slamming of the door on trade," Roberto Azevêdo, the WTO's director-general, told the Financial Times in June. "Quite the contrary, we need to get trade going." [6]

But there is a growing chorus of voices that disagree vehemently with that conclusion. "Right now we are at the delegitimization stage of the Free Trade 101 folks," says Michael Stumo, chief executive officer of the Coalition for a Prosperous America, a Washington-based think tank that advocates a more restrictive kind of trade policy.

Stumo and likeminded opponents of the current global trade system don't dispute the assertion that free trade has lifted hundreds of millions from poverty in recent decades. But they point out that the vast majority of those people reside in developing nations, particularly in Asia, while advanced economies may have paid the price for it.

"Globalization, the way it's been implemented, has delivered a very bad, unhappy situation for millions of people in the top 20 countries of the world," says Stumo's colleague, Jeff Ferry, who serves as the organization's research director.

According to research done by former World Bank economist Branko Milanovic, workers in developing countries—predominantly China, India, Thailand, Vietnam and Indonesia—have reaped substantial benefits from globalization that occurred between 1988 and 2008. [7] Rich citizens of advanced economies—call them the elites—also benefited. Who did not? The lower middle class in the rich world, says Milanovic. And more and more residents of those economies are coming to believe that the much-touted gains from trade have evaded them and that it is time to do something about it.

Yet there is considerable evidence that residents of wealthier nations have indeed benefited from trade. The Obama administration, which pushed but failed to finalize the TPP accord before it left office in January, enumerated those benefits in a May 2015 document assembled by the White House's Council of Economic Advisers. [8] The document said that:

- Trade agreements lower foreign barriers to U.S. exports
- Exporting firms pay higher wages to U.S. workers than non-exporting firms

- The lower prices on imported goods that trade allows have significantly boosted the purchasing power, and thus the real wages, of middle-class Americans
- Trade increases the productivity of businesses and the broader economy
- Trade has produced significant benefits for U.S. agriculture and services firms

All of that equals faster economic growth, trade enthusiasts say. One well-known 2008 study by economists Romain Wacziarg and Karen Horn Welch found that countries that liberalized their trade regimes grew faster by about 1.5 percentage points than they did before liberalization. [9] And there are a host of similar studies. [10]

A major problem for free trade, proponents argue, is one of optics: The gains from it are diffuse—low prices at Wal-Mart, for example—while the harmful effects are concentrated and highly visible in terms of displaced workers, shuttered factories and lower incomes. Making a better argument for trade is a big part of the solution, trade supporters say, as is compensating the losers from trade through programs such as the U.S. Trade Adjustment Assistance program, which offers retraining, job search aid and income subsidies.

## American Support for Free Trade Declining

**Most still believe free-trade deals are good for the U.S**


Source: Katie Simmons and Bruce Stokes, "Populism and Global Engagement: Europe, North America and Emerging Economies," Pew Research Center, Dec. 15, 2016, http://tinyurl.com/z9kupuj

Although a plurality thinks free-trade agreements have benefited the United States, the percentage of Americans who believe free trade is a bad deal has risen 12 points since 2014.

Disruptions from trade, as with any economic change, cause some jobs to vanish and others to emerge. This kind of churn is healthy and normal in an economy. Yet it is much more difficult to deal with when a nation has a weak social safety net, as does the United States, says economic historian William Bernstein. "You can't have free trade without a generous social safety net, especially healthcare coverage," says Bernstein. Consider, he says, that the loss of a manufacturing job in the United States can mean the loss of that worker's healthcare insurance, a limited period of unemployment insurance compensation (26 weeks in most states) and often a lower-paying replacement job in retail or healthcare. The United States spends far less than other advanced economies on programs to help workers dislocated by trade, according to a study by the Brookings Institution, a centrist Washington-based think tank. [11]

Another problem, free trade advocates say, is that, while advanced economies are gaining from free trade, the gains are not evenly distributed. While trade went gangbusters in recent decades, the real incomes of some two-thirds of households in 25 rich nations were stagnant or fell from 2005 to 2014, according to a July 2016 report by the McKinsey Global Institute. [12] A survey in the study found that those workers whose incomes did not rise had negative views of trade and immigration.

A better safety net would smooth the rough edges of free trade by helping those displaced by it regain their footing, improving education so more workers can benefit from trade and even redistributing more of the gains through the tax code, according to Matthew Slaughter, dean of the Tuck School of Business at Dartmouth College and former economic adviser to President George W. Bush. "There are decades of research that says first best policies are to continue to be connected to the global economy and use the fiscal regime of taxes, transfers and other policies to create and adequately fund a social safety net to those who aren't being directly helped by trade," says Slaughter.

Opponents of the current global system say this is off the mark. They maintain that so-called free trade has actually been rigged trade. The underlying idea of free trade, 19th century British political economist David Ricardo's theory of comparative advantage, held that residents of all countries could benefit by focusing on producing things they were best at. But that system also assumed a world in which all nations played by the same rules. And that, say critics, has not been the case over the last 70 years.

"The premise of our trade negotiations since 1950, whether we were negotiating with the European Union, Korea, Japan, or whoever, is that we're all playing the same game," says Clyde Prestowitz, president of the Economic Strategy Institute, a Washington-based think tank. "That premise is wrong. We're playing tennis and they're playing football."

He points to non-tariff measures used by U.S. trading partners that give unfair advantages to companies manufacturing within their borders. These range from interventions to keep their currencies artificially low (which benefits exporters) to industrial subsidies, state-owned companies and national champions, intellectual property theft and more.

"There are lots of ways outside of tariffs to preference your own companies," says Stumo. "Our trade partners are using all of them, and we are not."

Even though the United States and European nations continue to maintain protectionist trade policies in agriculture, Stumo's argument is gaining traction among citizens of advanced economies. And it has become intertwined with concerns about immigration, whether those concerns stem from resentment about competition for jobs, strains on social safety nets or fears about terrorism.

As economists, policy makers and ordinary citizens debate the merits of free trade, here are some of the main issues under discussion:

# Weighing the Issues

### Is globalized trade the main reason for manufacturing job losses in the United States and other developed countries?

Economic truth, like beauty, is frequently in the eye of the beholder. There are many quality studies and reports on the topic of job loss, and they often tell different tales.

There is widespread agreement that while manufacturing output has continued to grow in recent decades, manufacturing employment has not. Manufacturing provided a quarter of all U.S. jobs in the early 1970s, and that has fallen to less than 9 percent today. [13]

An often-cited 2015 Ball State University study found that while productivity, trade and domestic demand all affected U.S. employment in the 2000-2010 period, almost 88 percent of manufacturing job losses over that decade was due to the growth of productivity—that is, fewer workers were needed to produce the same output because of automation, computerization and robots. It found that trade deficits (net exports have been negative since 1980) were responsible for only about 13 percent of job losses during the period. [14] (There is some overlap between the effects of trade and productivity, so the numbers slightly exceed 100 percent.)

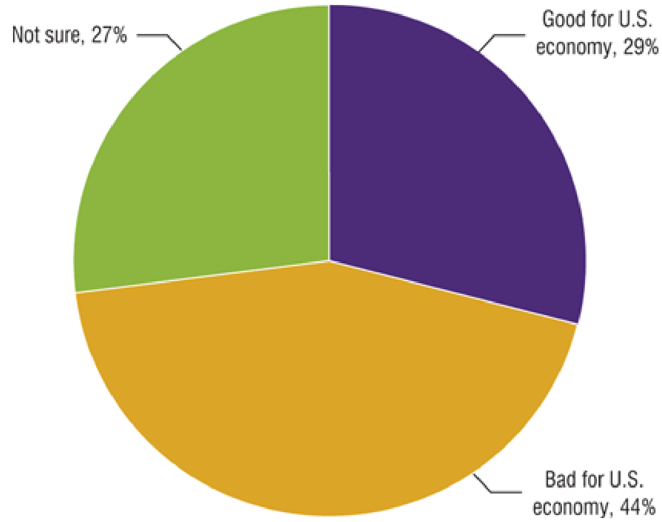
If the United States had remained at 2000 levels of productivity through 2010, the Ball State study found, 20.9 million manufacturing workers would be have been employed. Instead, there were 12.1 million that year. "Manufacturing production remains robust. Productivity growth is the largest contributor to job displacement over the past several decades," the study said.

And yet recent, well-respected research by economist Susan Houseman of the W.E. Upjohn Institute for Employment Research has called into question those and similar findings. [15] The underlying data on productivity and trade are not reliable, Houseman found, as national statistical systems were not designed to measure many of the transactions occurring in today's global economy. She also doubts statistics on the growth of manufacturing output, pointing to questionable ways it is measured in national accounts.

"The reason for manufacturing's anemic performance is that U.S. consumers and businesses are buying more imported products, and American exports have not risen commensurately," Houseman said in an October 2016 interview with the Washington Post. "Instead of manufacturing their products in the United States and exporting them to foreign markets, U.S. multinational companies now often locate production overseas to take advantage of lower labor costs and taxes, among other factors.” [16]

## NAFTA Unpopular in the U.S

**44 percent think agreement has been bad for the economy**




Source: “Bloomberg Politics National Poll,” Bloomberg, p. 12, March 19-22, 2016, http://tinyurl.com/zqf3yox

Americans are skeptical about the benefits of the North American Free Trade Agreement (NAFTA) for the U.S. economy. In 2016, 44 percent thought the free-trade pact has been bad for the U.S. economy, 29 percent thought it was positive and 27 percent were unsure.

One widely cited 2015 economic paper estimates that rising competition from Chinese imports in the 1999-2011 period resulted in U.S. job losses of between 2 million and 2.4 million. Total manufacturing employment fell by 5.8 million jobs during that period. [17]

“Trade deficits, even in times of strong growth, have negative, concentrated impacts on the quantity and quality of jobs in parts of the country where manufacturing employment diminishes,” says Jared Bernstein, a former Obama White House economic adviser who is now a senior fellow at the Center on Budget and Policy Priorities, a liberal Washington-based think tank.

And trade with low-wage nations has hurt pay levels, too, according to a 2013 study by the Economic Policy Institute, a left-leaning Washington research group. Growing trade with emerging economies lowered the average wage for a typical U.S. blue collar worker by 5.5 percent, or about $1,800, in 2011, according to the report, and one-third of that effect was due solely to growing trade with China. [18]

The paper makes the point that while trade increases overall national income, it also affects how income is distributed *within* a nation. And because the United States has integrated with poorer global economies, it has increased production in capital-intensive industries and reduced production in labor-intensive industries. This leads to lower demand for labor, and so lower wages, and increased demand for capital services, resulting in higher wages for those in that sector.

The loss of American manufacturing jobs was inevitable, according to Brad DeLong, an economic historian at the University of California, Berkeley. It is just the latest in a number of employment shifts that have occurred in human history, such as the loss of agricultural employment as farming methods became more efficient and people left the fields for factories. Trade accords such as TPP, NAFTA and China’s 2001 entry into the WTO “are not a big part of the long-run decline in the manufacturing job share,” DeLong wrote. [19]

But even if this is true, “the move from agriculture employment to manufacturing employment was a good thing,” says Ferry of the Coalition for a Prosperous America, “because the latter paid better. But manufacturing to services, especially to retail and healthcare, is not a good thing, because those pay worse.”

Either way, it is becoming clear that U.S. industries more exposed to import competition have been hardest hit, according to a 2016 study by economists David Autor, David Dorn, and Gordon Hanson. [20] And employment in the local labor markets in which those industries are concentrated has also suffered. Labor immobility—geographical or skill-based barriers to workers moving between jobs—and other frictions in the U.S. economy mean that entire communities and regions have been devastated by trade and unable to adjust for years.

## Can globalized trade be reversed?

Many Americans need look no further than the phone they're holding in their hand to understand the state of much of modern manufacturing.

Apple designs the iPhone at its headquarters in Cupertino, Calif., and then farms out the manufacturing of the phone's many parts to dozens of companies around the world. The touchscreen controller and flash memory are manufactured in the United States, and various other parts are made in Italy, Germany, Taiwan, Japan and South Korea. At the end of the process, the phone is assembled in a factory in Shenzhen, China, by Foxconn, a Taiwanese firm. [21]

The iPhone and many other products in daily use are truly global. And global supply chains (sometimes called global value chains) account for as much as 80 percent of global trade, according to a 2015 report by London's Standard Chartered Bank. Intermediate goods, those that will go into other final goods, are about 60 percent of global trade. [22]

These statistics weaken the case—one put forward by Trump advisers—that, because of trade liberalization, products once made in the U.S. have been moved to factories in low-wage nations that then ship them back for sale to American consumers. "The Trump people think of international trade competition as between end products," says Claude Barfield, a former consultant to the U.S. Trade Representative, who is now a scholar at the American Enterprise Institute, a Washington think tank that generally supports free trade. "It no longer largely is. Fifty percent of the trade of the U.S. and other developed countries is parts and components, it's no longer final products."

Every dollar of Mexican exports to the U.S. contains 40 cents of American output, according to a study by the Washington-based Woodrow Wilson International Center for Scholars. [23] The auto industry, which spans North America, is a prime example. "You cannot run a plant in Michigan without Mexican imports," according to Luis de la Calle, an economist and former official at Mexico's Ministry of Economy. [24]

So, for many U.S. firms that use inputs from Mexico, Canada or China, or manufacture parts there, punitive tariffs on trade partners or U.S. withdrawal from free trade deals—both advocated by Trump—could mean suddenly higher sourcing costs, disruptions to complicated value chains that span multiple countries, even stranded or seized production assets. [25] For consumers, that portends higher prices for shoes, apparel, toys, furniture, electronics, mobile phones, autos and hundreds of other products whose prices are kept low by value chains.

"Even if no [U.S.-China] trade war occurs, protectionist tariffs will severely disrupt global value chains of not only U.S. and Chinese firms, but thousands of foreign subsidiaries that have embedded themselves in cross-border production networks," according to global trade scholar and adviser Alex Capri of the National University of Singapore Business School. "If Trumpian policies disrupt these value chains, it's likely that many U.S. firms and U.S.-based foreign subsidiaries will relocate their activities elsewhere, creating the exact opposite outcome intended."

Trump trade adviser and former University of California economics professor Peter Navarro says he would like the United States to unwind and repatriate global supply chains so that more, or even most, components of final goods assembled in the U.S. are also made here. Too much of American manufacturing, he says, is merely assembling parts produced in other nations. [26]

Of course, bringing global supply chains back to the United States would cause disruptions, according to Greg Autry, a professor at the University of Southern California and co-author with Navarro of "Death by China: Confronting the Dragon – A Global Call to Action." "We moved our supply chain to Asia in about two decades," he told The New York Times in December. "You certainly can do it in the U.S. a whole lot faster. It's going to take a few years, but it's going to be a much better America." [27]

That may sound like a good idea to some, but replicating the production that goes on in factories in China and elsewhere would be a massive, costly, long-term effort. Even U.S. companies that compete with imported goods use imported components themselves to produce their own final products. The share of imported components in American manufactured goods rose to 34 percent from 24 percent between 1998 and 2006, according to a 2010 study by the federal government's Bureau of Labor Statistics. [28] So disrupting supply chains or taxing imports would drive up the prices of imported goods—as well as the prices of many goods that carry the label "Made in the USA."

## Would eliminating or reducing the trade deficit boost U.S. economic growth?

Trump's economic and trade advisers call persistent U.S. trade deficits—especially those with China, Germany, Japan, Mexico and South Korea—a major drag on economic growth. They state unequivocally that reducing the U.S.'s overall $500 billion trade deficit, by increasing exports and decreasing imports, would increase growth. [29]

And there's a certain elemental truth to that statement. Consider the formula for GDP:

*GDP = Consumer Spending + Business Investment + Government Spending + (Exports – Imports)*

So rising imports naturally subtract from GDP. If they fall, and exports rise, GDP is greater.

And it's pretty clear that reducing the trade deficit would increase manufacturing employment, though by how much is a matter of great debate. Nobel economics laureate and New York Times columnist Paul Krugman estimates that completely eliminating the trade gap in manufactured goods (the U.S. runs a surplus in services) would add 2 million manufacturing jobs. [30]

When an economy is going full tilt, a trade deficit can be a good thing, as supply-side factors such as limits on available labor can restrict how much is produced domestically, so consumers turn to imports to meet their consumption needs. That helps hold inflation in check, among other things. But in an economy not at full capacity, which is the situation now with many U.S. workers still unemployed or underemployed and a falling labor participation rate, a trade deficit can be a drag on demand.

Also, the United States is borrowing from abroad to finance its persistent trade deficits. As Gary Hufbauer, a senior fellow at the Washington-based Peterson Institute for International Economics, points out, if net foreign claims on the United States, now about $7.3 trillion, become a very high fraction of U.S. GDP, the burden of paying interest and dividends on the debt could become a significant drain on the economy. [31]

So getting closer to a balance on trade is a good idea, yet how to do it remains an open question. "Ideally, the deficit would be eliminated by a combination of rising U.S. exports stemming from a more equitable global trading environment," says Prestowitz. "In that case, eliminating the trade deficit would indeed stimulate growth."

But the evolving Trump trade doctrine seems to be to deal with deficits on a country-by-country, or bilateral, basis, renegotiating each deal to ensure that it "must increase the GDP growth rate, decrease the trade deficit, and strengthen the U.S. manufacturing base," as advisers Navarro and Wilbur Ross, Trump's new Commerce secretary, wrote last year. [32]

University of Southern California professor Greg Autry favors repatriating supply chains to the United States.

This idea, most economists say, is unworkable. "If you reduce the deficit with one country, it doesn't stand to reason that the U.S. is the next cheapest producer of the goods that you're not importing from that country. The next cheapest producer is likely some other foreign country. So you'll just shift U.S. imports … from, say, Mexico to Brazil," says Hufbauer.

Tariffs that reduce imports and invite retaliation from trade partners are also a flawed solution. "If we reduce our imports and other countries retaliate by reducing the amount they import from us, then the net result is less growth," says Brad Setser, an expert on geoeconomic studies at the Council on Foreign Relations in New York. "If you just slap a tariff on all goods and it's a big enough one, and we don't immediately start producing those goods in the U.S., in the short run you have to pay more for the same set of goods, that's less money to spend on other things. And that is contractionary."

Also, it's important to remember that multiple factors create trade deficits, including Americans' propensity to spend too much and save too little and the ability of many nations to produce the goods we buy more cheaply than the United States can. So a good start might be to encourage Americans to balance their budgets.

Reducing the relative value of the dollar would also help, although it's complicated by the fact that it is the world's reserve currency—that is, many nations use dollars and dollar-denominated assets to make international payments, defend the value of their own currency, or just for a rainy day, which boosts demand for the U.S. currency.

The current "strong dollar" policy, adopted in 1995 by then-Treasury Secretary Robert Rubin, maintains that a robust dollar exchange rate is always in the best interests of the nation. But economists are beginning to question that assumption, as the policy has at times made U.S. exports more expensive on world markets. Trump may have already signaled the beginning of the end of that policy in an interview with The Wall Street Journal shortly before taking office: "Our companies can't compete with them now because our currency is too strong. And it's killing us." [33]

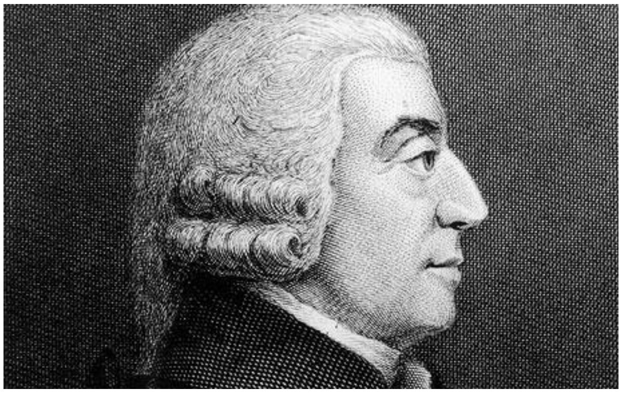
Convincing U.S. trade partners to swear off practices that keep their own currencies artificially cheap against the dollar would help too, most economists agree. "We should make sure, as best we can, that the dollar is relatively fairly valued in international markets," says Jared Bernstein, "and then let the competition rip."

## Background

## “An Irreducible and Intrinsic Impulse”

Humans, wrote economic philosopher Adam Smith, have a natural propensity to “truck, barter, and exchange one thing for another.” [34] That propensity, arguably, has driven world history.

The Silk Routes—bringing fabrics, spices and gunpowder west in exchange for furs, metals, dyes and other items going east—first connected ancient empires in Rome, China and India. Muslim traders were largely responsible for the spread of their new faith west to Spain and east to Indonesia. The quest for pepper, cinnamon and other Asian spices drove exploration of the globe by Vasco da Gama, Christopher Columbus and other Europeans. Trade also spread bubonic plague from Himalayan rodents to the Middle East, Europe and China, devastating entire populations and economies.


Economist Adam Smith helped promote free trade.

Trade created empires—and destroyed them. Historians link the fall of Rome to the depletion of its gold and silver reserves, exchanged over centuries for Eastern luxury goods. The establishment of the Dutch and English East India companies, which drove world trade for two centuries, helped pave the way for Western dominance of the world economy and the vast disparities in the wealth of nations that remain in place today.

Trade, writes William Bernstein, the economic historian, “is an irreducible and intrinsic impulse” that “has profoundly affected the trajectory of the human species.” [35]

In the modern era, technologies such as the steam engine and steelmaking entwined nations much more tightly through trade. Yet the path to the current global system has never been straight or seamless, and reversals, though usually temporary, have come as often as advances.

Perhaps the founding argument for modern free trade was the theory of comparative advantage, put forward in 1817 by political economist Ricardo. It challenged the popular mercantilist view that accumulating gold via a national trade surplus was the true purpose of trade. Instead, said Ricardo, all nations can benefit through trade if they concentrate on making products in which their advantage is relatively greatest. Essentially, he said, trade is not a zero-sum game, but instead can benefit all who partake in it.

Within a few decades, the free trade views of Ricardo, Smith, and others gained traction in Great Britain and the rest of Europe, leading to the repeal in 1846 of England’s draconian Corn Laws, which held down grain imports, and subsequently the Cobden-Chevalier Treaty of 1860, which slashed tariffs between Great Britain and France and led to tariff-cutting throughout Europe. Much lower trade barriers, together with rapidly falling prices for transportation and communication, ushered in an era of free trade in the second half of the 19$^{th}$ century.

That was not, however, the end of world economic history. Exploration, colonialism and trade had created vibrant agricultural producers in the New World and elsewhere. As their economies grew and shipping costs continued to drop, the United States, Canada, Argentina, Australia and Russia began to flood Europe with grain imports in the last two decades of the 19$^{th}$ century, hurting farmers there and leading to a new era of anti-trade sentiment and rising import tariffs. The fall in shipping costs, however, also helped keep international trading volumes robust.

In a major blow to free trade, in the 1920s Republicans in the United States pushed for higher tariffs, partly because of a resurgence of isolationist ideas after the First World War and partly to appeal politically to farmers, who, unlike those in other sectors of the American economy, did not prosper in the Jazz Age. [36] Several new tariffs were enacted, and European and Latin American nations retaliated. The infamous Smoot-Hawley Tariff of 1930 helped push up the average tax on imports to nearly 50 percent. Its name has since become synonymous with protectionism. [37]

“While economic historians do not believe that the Smoot-Hawley tariff caused the Depression, the high tariffs contributed to the downward spiral of trade as other countries retaliated against the United States,” wrote Dartmouth economist Douglas Irwin in “Free Trade Under Fire.” [38]

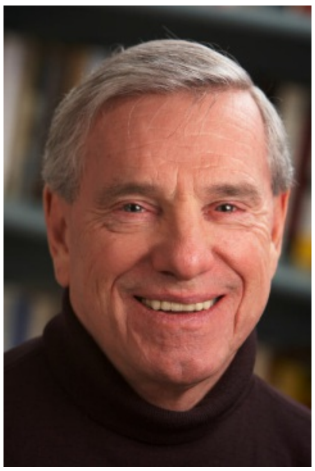
Were Smoot-Hawley and its aftereffects a major cause of the Second World War? Historians disagree on the issue, but it is clear that the tariffs increased economic isolationism and nationalism around the world, conditions often conducive to conflict. Historian Bernstein thinks they did more than that. “Smoot-Hawley and retaliatory tariffs were absolutely a contributing factor to World War II,” he says. “Because of them, Germany couldn’t export and so couldn’t pay reparations imposed on them after the first war.”

The U.S. State Department of the time seemed to agree. Cordell Hull, President Franklin D. Roosevelt’s secretary of State, was a firm believer that free trade promoted prosperity and peace. [39] And in the aftermath of World War II, a famous 1945 State Department document, “Proposals for Expansion of World Trade and Employment,” made the case that a system of international free trade could help avoid another global catastrophe. Unless countries act together, the document stated, “they will act at cross purposes and may well do serious damage to each other. But if they do act together, there is every possibility that the peoples of the world may enjoy, in our lifetime, a higher degree of prosperity and welfare than they have ever had before.” [40]

## Blueprint for a New Era

Using the document as a blueprint, 23 nations met in Geneva in 1947 and hammered out an agreement unprecedented in human history, the General Agreement on Tariffs and Trade, or GATT, the first multilateral trade agreement and the one that launched a new era of trade and globalization. [41]

Some economists and historians contend, however, that a fundamental mistake was made at the beginning of this era, the effects of which would only materialize decades later. At the seminal 1944 economic conference held in Bretton Woods, N.H., delegates from 44 nations met and designed the postwar economic and trade system. [42] British economist John Maynard Keynes, a principal architect of that system, advocated for a system of balanced trade, in which nations with chronic trade deficits would be helped and those with chronic surpluses would be given incentives to return to balance. The United States, which then enjoyed the world’s largest trade surplus, vetoed this system in order to preserve its trade advantages. [43] (The U.S. balance of trade went negative in the 1970s and now runs a deficit of about $500 billion a year.) [44]



Clyde Prestowitz: “We’re playing tennis and they’re playing football.”

That sowed the seeds of “a persistent global structure in which a handful of countries now make up two-thirds of the global current account deficit, and another handful combine for two-thirds of the surplus,” says Prestowitz. (The current account is a broader measure of trade that includes the balance of trade plus smaller components, including interest and income from assets held abroad.)

Still, for multiple decades, the GATT pushed free trade forward at a dizzying pace. Seven negotiating rounds largely demolished tariffs among member countries. “The reduction in trade barriers and the stability of tariff policy in most countries in the decades after 1947 have permitted the expansion of world trade to proceed unchecked,” Irwin wrote. [45]

The GATT was succeeded in 1995 by the World Trade Organization, which coordinates and regulates trade among member countries and resolves disputes. Whether or not the WTO has been effective, however, is a matter of debate. [46]

Other developments advanced economic globalization. Not least among them was Malcolm McLean’s 1956 invention of the intermodal shipping container, which dramatically reduced shipping and port costs because it could be used to move freight from ship to rail to truck.

In addition to multinational GATT—and later WTO—talks, nations pursued broad trading blocs in the 1990s, averaging nearly 30 signed accords a year during that decade. [47] Two of the largest were NAFTA, signed in 1992 by the United States, Mexico and Canada, and Mercosur, a 1991 treaty encompassing Argentina, Brazil, Paraguay, Uruguay and Venezuela. A monumental development was the economic integration of Europe, begun in 1951 with the Treaty of Paris, which established the European Coal and Steel Community. The immediate idea behind the trading bloc was to create a single coal and steel industry by removing barriers to trade on those goods within continental Europe. The larger underlying idea was to remove those commodities most necessary for war from the control of national governments, thereby preventing another devastating conflagration like the one that had ended just six years earlier with much of the continent in ruins. [48]

That agreement was the forerunner to the European Union (EU), established in the 1992 Maastricht Treaty, which put in place a single market with free movement of people and goods, eventually among 28 nations. Seven years later, a monetary union was established, with 11 EU states adopting the euro currency, and eight others joining later. Since then, the euro has become the world’s second largest reserve currency behind the dollar. Not all EU member countries have adopted the euro, for various political and economic reasons.

## The EU Under Scrutiny

The economic success of the EU is under debate. Certainly there have been hiccups, many of them due to the fact that there is a monetary union among 19 nations but no fiscal or political union. [49] This created major problems during the global financial crisis of 2008-2009. More recently, refugees from conflicts in the Middle East have tested the EU’s commitment to free movement of people across borders.

Still, the noneconomic gains may outweigh all of that, says historian Bernstein: “Since time immemorial, since the reign of Charlemagne, the major European powers have been at war with each other. And now, because of the EU, the idea of a shooting war between Western European powers is incomprehensible.”

However, opponents of freewheeling free trade call China’s WTO entry in 2001 a turning point, especially for the United States. Allowing China into the WTO “was the worst political and economic mistake in American history in the last 100 years,” according to Navarro. [50] He and many other economists and trade analysts say China didn’t—and doesn’t—play by global free trade rules. They argue that while

China may technically adhere to the lower tariffs negotiated by the GATT and WTO, it engages in a host of other unfair trade practices, including currency manipulation, illegal export subsidies and intellectual property theft, among others. And China is not the only nation accused of gaming the free trade system. Nations such as Japan, South Korea, Taiwan, Singapore and even Germany have done so, critics assert, often through interventions to keep their currencies undervalued and thus their exports artificially strong. (Germany is taking advantage of a "grossly undervalued" euro to exploit the United States, Navarro said in January.) [51]

### U.S. International Trade Deficit Rises

**Both exports and imports decreased in 2016**


Source: "U.S. INTERNATIONAL TRADE IN GOODS AND SERVICES: December 2016," U.S. Bureau of Economic Analysis, U.S. Census Bureau, Feb. 7, 2017, http://tinyurl.com/lb6vwpk

The U.S. international trade deficit hit $502.3 billion in 2016, an increase of about $2 billion from 2015 and the highest the deficit for trading in goods and services has been since 2012, when it was nearly $537 billion.

Many developing nations also oppose the post-World War II free trade regime, which, they say, has been unfair to them, largely because it has not reduced or eliminated rich countries' agricultural subsidies and import barriers. Citing those inequities, developing nations, many of whom rely on farm exports, collectively derailed the latest round of WTO trade talks, the so-called Doha Development Round. As a result, these developing nations expected "that developed countries would open their markets completely to developing countries, which would not have to do anything in return," according to Irwin. [52] Negotiations collapsed in 2008 and have not been revived.

And then came the financial crisis and Great Recession of 2007-2009. Falling demand sent world trade volumes plummeting. Trade recovered by 2011, but real damage had been done, especially in the EU, where resentments from the center (mainly Germany) about helping the periphery (Portugal, Italy, Greece and Spain), boiled over and continue to simmer.

Worse, strife in the Middle East, particularly in Syria beginning in 2011, flooded Europe with refugees who, once they got into Greece or another EU state, could move across borders easily. Resentment of those migrants significantly diluted enthusiasm for the European project and brought a rejuvenation of right-wing, anti-immigrant political parties throughout Europe. And in 2016, Britain shocked the world by voting to exit the EU.

# Current Situation

## Doubts About Trade Begin to Surface

By many measures, opposition to increased trade has grown among U.S. citizens, too.

A March 2016 Bloomberg News poll found that a plurality of Americans (44 percent) believe NAFTA has been negative for the U.S. economy (29 percent said positive and 27 percent had no opinion). And 82 percent of those surveyed said they would be willing to pay more for domestically made products. [53] The Pew Research Center found that, while Americans overall continue to favor trade, the difference between those who think trade agreements with other nations have been a good thing for the United States and those who say they have been a bad thing has narrowed, from 59 percent to 30 percent in 2014 to 51 percent to 39 percent a year ago. [54]

Interestingly, a recent Wall Street Journal/NBC News Poll showed that ideas about trade—like so many other issues—are diverging between Republican and Democratic voters. [55] Democrats who say free trade has helped more than hurt rose to 57 percent, from 34 percent a year ago. Among Republicans, however, only 27 percent viewed free trade favorably, and more than half said it hurt the country, the same as a year ago.

Today, among politicians, anti-trade sentiment spans the political spectrum. Republican Donald Trump and democratic socialist Bernie Sanders both railed against NAFTA and other trade deals on the campaign trail in 2016. Democratic presidential nominee Hillary Clinton, who supported TPP while she was secretary of State, abruptly reversed her position and opposed it during the election.

## A New Administration

In his inaugural address, Trump erased all doubts that protectionism will be central to his agenda: “We must protect our borders from the ravages of other countries making our products, stealing our companies and destroying our jobs. Protection will lead to great prosperity and strength.”

The first month of his administration is proving that Trump’s campaign promises and speeches were not empty rhetoric. He appointed Navarro, a prominent China critic, to lead his newly created National Trade Council, and Robert Lighthizer, another China critic, as his chief trade negotiator. Ross, a billionaire financier who has called for pro-American trade policies, is Trump’s Commerce secretary.

In a September 2016 paper, Navarro and Ross spelled out Trump’s trade policy. [56] They laid blame for U.S. economic woes such as slow growth, deindustrialization and wage stagnation largely on a trade imbalance with China and five other nations: Canada, Germany, Japan, Mexico and South Korea. And they called for a rebalancing of those trade relationships through renegotiation of existing trade deals, as well as defending against other nations’ “trade cheating” by all available means, including punitive tariffs.

On the Monday after his inauguration, Trump officially withdrew the United States from the TPP and his advisers have declared the EU-U.S. negotiations on TTIP dead. In addition, the White House has taken initial steps toward renegotiating NAFTA, which the president has called “the single worst trade deal ever approved in this country.”

The new administration says it plans to eschew multilateral trade pacts in favor of bilateral deals with the United Kingdom, Japan, New Zealand, Malaysia, Thailand and Australia. The idea, says trade scholar Barfield, is to take advantage of American economic muscle in one-on-one negotiations. “They hope that the market power of the U.S. would force whatever country we’re dealing with to bow to our will, and we’ll get all the things we want and not have to give anything up,” he says. “It’s something they couldn’t accomplish in multilateral negotiations.”

Navarro seems to agree with that assessment. “The problem with multilateral deals is we reduce our bargaining power, we surrender our sovereignty,” he told Fox News on Jan. 29. Yet it is far from clear that the Trump administration can secure better terms through bilateral trade agreements than previous negotiators got through multilateral deals.

In a trade policy statement on March 1, the White House asserted that American voters have rejected the current framework for international trade, that the status quo is unacceptable, and that these facts mandate a new approach. [57] It said the United States will use “all possible sources of leverage” to ensure fair market access for U.S. goods and services, including strict enforcement of U.S. laws, changes to current trade agreements and “reciprocity”—meaning that barriers to U.S. products in other nations will prompt similar restrictions on entry to the U.S. market. The White House also expressed discontent with major existing trade agreements and said it did not regard WTO rulings as necessarily binding on the United States: “The Trump Administration will aggressively defend American sovereignty over matters of trade policy.”

Nor is the new president shying away from using the bully pulpit—or bully twitter account—to keep U.S. jobs from going abroad. Trump has already leaned on several companies, including Carrier, a unit of United Technologies, and Ford Motor Co., into abandoning or altering plans to build factories abroad.

More worrisome to large manufacturers, perhaps, are Navarro’s comments about taking measures to unwind and repatriate international supply chains. [58] Toward that goal, the White House is pushing for a new corporate tax code that would tax imports and exempt exports, a so-called border adjustment levy. The objectives of the move, which congressional Republicans have advocated for some time, are twofold: raise revenue on imports to compensate for a lower overall corporate tax rate and make off-shoring of production less attractive to

WTO's Roberto Azevêdo: "What we don't need is the slamming of the door."

U.S. firms.

Supporters of the change, which would be the linchpin of a long hoped-for overhaul of the corporate tax code, say it would merely implement in the United States a scheme similar to the value-added tax (VAT) that other nations use. (A VAT, common in the EU, imposes a tax at each point that value is added in the production process of a good, including at final sale.) Opponents say the border adjustment levy looks like an export subsidy with a protectionist structure and would hurt retailers, who import much of what they sell. Others say the dollar would strengthen due to the tax, moderating import prices, but there is little consensus among economists exactly what the border tax would do to the economy.

It is not yet clear how the plan will be implemented, if at all, but if it strays far from an ordinary VAT it will begin to resemble an import tax and export subsidy, and will invite retaliation from trading partners, says Chad Bown, a senior fellow and trade expert at the Peterson Institute. "If so, the best-case scenario has them trying to work it out through negotiations or through a formal WTO dispute," says Bown. "The worst-case scenario has them acting unilaterally with retaliation."

And by driving up prices of imported goods at Wal-Mart and other retailers, the border tax also may be bad politics. "I'm not sure the people of the Congress should be thinking in terms of responding to white rural middle-class anger by doing a corporate tax cut to raise consumer prices," Peterson Institute President Adam Posen said at a recent event focused on the border tax proposal.

### International Issues

Meanwhile, as U.K. Prime Minister Theresa May begins to navigate her nation's difficult departure from the European Union, movements to exit the alliance are growing in other nations, including the Netherlands, France, Italy, Austria and Sweden. [59] Even if some of the nationalist parties pushing for an exit are small and unlikely to achieve referendums, their growth and message cannot be ignored.

"In the wake of anti-establishment referendum votes in the U.K. and Italy [where voters in December rejected constitutional changes], Europe's leaders have yet to find convincing answers to the wave of political disaffection sweeping the continent," says Iain Begg, a fellow at the London School of Economics.

And financial markets, initially buoyed by what they considered to be pro-growth Trump policies, are beginning to worry. Protectionism was named the top threat to U.S. growth by over half of respondents to a January CNBC survey of economists, fund managers and strategists, the first time in the survey's history that a majority agreed on a single concern. [60]

"Trashing the Mexican economy with tariffs and other bad policies is like throwing rocks through your neighbors' windows, thereby reducing the value of YOUR home," Robert Fry, chief economist at Robert Fry Economics, told the survey.

## Looking Ahead

### Uncertain Times

With new economic and trade policy being set daily, it's far from clear what international trade will look six months from now, let alone five years down the road. Predictions of the future, therefore, range from rosy scenarios to disaster.

The Trump administration foresees a U.S. economy that looks very different from today's, with an American manufacturing renaissance at the heart of it.

"We envision a more German-style economy, where 20 percent of our workforce is in manufacturing," Navarro recently told CNBC. (About 9 percent of American workers are currently in that sector.) "And we're not talking about banging tin in the back room. We're talking about high technology across the board, whether it's computer chips or cars or anything in between." [61]

Navarro dismisses the idea that increasing automation will continue to thin out factory floors, saying there is room for both robots and humans in this new economy. He also predicts a "robust domestic supply chain that will spur job and wage growth." [62]

And trade will continue to flow, say other critics of the current system. Prestowitz predicts separate bilateral U.S. trade deals with the United Kingdom and Japan, as well as a new NAFTA "which might actually turn out to be good for both Mexico and the U.S." In fact, Japan, the United Kingdom and Korea might all become part of a loose free trade and customs area, he says.

Others are less sanguine. If multi-country supply chains are disrupted or if a renegotiation of NAFTA is bungled, it could hurt U.S. auto workers and consumers, according to New York Times economic columnist Neil Irwin. [63]

But it would take a great deal of misguided effort to undo 60 years of trade and investment liberalization, says Barfield. "The Trump people at their worst probably couldn't roll that back more than a bit," he says.

Setser of the Council on Foreign Relations disagrees, saying that utter chaos is certainly within the realm of possibility: “The worst-case scenario in the short run for the global economy is that the U.S. does something big and broad to punish China for cheating and China responds by weakening their currency, and then the U.S. responds with another round of tariffs.” That would lead to a currency war, he says, with all countries that compete with China facing pressure to depreciate alongside of China, “with a lot of collateral damage.”

Gary Hufbauer of the Peterson Institute for International Economics

And some economists fear that Trump’s immigration and trade policies could send the United States, Mexico and China into recession. According to an economic model Moody’s Analytics prepared for The Washington Post, up to 4 million U.S. jobs would be lost, and another 3 million potential jobs not created, if the Trump administration starts a trade war and U.S. trade partners retaliate. [64]

Europe could face its own meltdown, says Begg. “With two of the EU’s largest members, France and Germany, facing general elections in 2017 and the Dutch populist party led by Geert Wilders ahead in the polls for the election due in March, further electoral earthquakes may be on the horizon.”

It’s also possible, however, that the importance attached to manufacturing goods may subside as services—such as information technology services, business services, education and entertainment—become more productive, unbundled, and tradeable due the internet and other communications technologies. [65] Increased trade in services could be a solution to the current war over trade—or the next battlefield.

## About the Author

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## Chronology

| | |
|---|---|
| **1810s–1870s** | **Falling barriers, better transportation ramp up international trade.** |
| **1817** | British economist David Ricardo’s “On the Principles of Political Economy and Taxation” sets forth the comparative advantage theory of free trade, which holds that nations can benefit through trade if they concentrate on making those products in which their advantage is relatively greatest and purchase products for which their advantage is smaller. |
| **1846** | Great Britain’s Corn Laws are repealed, eliminating the last of hundreds of regulations and tariffs imposed over two centuries on English grain and grain imports. |
| **1860** | Cobden-Chevalier Treaty, an Anglo-French free trade agreement, slashes tariffs in the two nations. Other nations and cities join and tariffs throughout Europe fall. By 1875 nearly all of Europe is a low-tariff zone and an era of free trade ensues, accelerated by lower transportation and communication costs. |
| **1880s–1930s** | **Protectionism rises around the world.** |
| **1885–1900** | Cheap grain from the United States, Canada, Argentina, Australia and Russia begins to flood Europe, leading to a new era of anti-trade sentiment and rising tariffs. |
| **1922** | Protectionist Fordney-McCumber Tariff increases U.S. import duties to 40 percent or higher. |
| **1930** | Smoot-Hawley Tariff Act raises nearly 900 U.S. import duties further; Europe responds with retaliatory tariffs, leading to intensified nationalism globally. |
| **1939** | World War II begins; many historians cite economic protectionism and isolationism as contributing factors. |
| **1940s–1990s** | **Golden era of free trade begins, led by United States.** |
| **1945** | The U.S. State Department lays out a plan for countries “to harmonize their policies with respect to international trade and employment” in its Proposals for Expansion of Trade and Employment. |
| **1947** | The General Agreement on Tariffs and Trade (GATT) is signed by 23 nations, beginning a new era of increased trade and globalization. The first GATT round (Geneva) reduces 45,000 tariffs covering one-fifth of world trade. |
| **1951** | The Treaty of Paris establishes the European Coal and Steel Community, the first supranational international organization. |

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|---|---|
| **1986–1993** | GATT Uruguay Round leads to major tariff and subsidy reductions and introduces three new issues: trade in services, intellectual property rights and investment. |
| **1992** | Maastricht Treaty is signed, creating the European Union (EU), a single market with free movement of people and goods. |
| **1994** | North American Free Trade Agreement (NAFTA) takes force, creating a giant trade bloc encompassing the United States, Canada and Mexico. |
| **1995** | World Trade Organization is established in the Marrakesh Agreement and eventually grows to 164 members. |
| **1999** | Eurozone monetary union established among 19 EU nations. Initially an accounting currency, the euro becomes the world's second-largest reserve currency, after the U.S. dollar. Coins and notes enter circulation in 2002. |
| **2000s–Present** | **Multilateral talks founder and protectionism rises again.** |
| **2000s** | In a strategy of "competitive liberalization," the United States signs multiple bilateral and multilateral trade agreements, including accords with Jordan, Singapore, Chile, Australia, Morocco, five Central American nations, Peru and South Korea. This creates what some trade experts call a "spaghetti bowl" of rules and preferences that may undermine the multilateral trading system. |
| **2001** | WTO Doha Round launched, but eventually falters over agricultural tariffs, as well as diverging views of emerging and advanced economies. Talks fail at a 2003 WTO ministerial meeting in Cancun, Mexico, and collapse completely by 2008. |
| **2008** | Negotiations begin for a trade agreement among 12 nations called the Trans-Pacific Partnership (TPP), which would be the largest regional trade pact in history. |
| **2015** | TPP negotiations conclude with the signing of the agreement. |
| **2016** | The United Kingdom votes in a referendum to withdraw from the European Union, a move known as Brexit (June). The vote brings down Prime Minister David Cameron's government and sends the British pound to a 31-year low.… Donald Trump is elected U.S. president on a platform of economic nationalism and anti-immigration (November). His campaign trade positions include renegotiating NAFTA, labeling China a currency manipulator and bringing trade cases against China to halt its "illegal activities." |
| **2017** | Trump withdraws the United States from the Trans-Pacific Partnership and schedules meetings with Canadian and Mexican leaders to open NAFTA for renegotiation. New taxes on imports, aimed at promoting U.S. exports, are mulled in Washington. |

# Resources for Further Study

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### Books

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Hufbauer, Gary Clyde, and Euijin Jung, “U.S. Bilateral Trade Balances: A New Guide to Trade Policy,” Peterson Institute for International Economics, Nov. 15, 2016, http://tinyurl.com/jn83jon. Two experts at a think tank respond to Trump advisers’ assertions that reducing the trade deficit would increase GDP growth.

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### Reports and Studies

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## The Next Step

### Rise of Nationalism


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## Organizations

**American Enterprise Institute**
1789 Massachusetts Ave., N.W., Washington, DC 20036
202-862-5800
www.aei.org
Think tank that advocates in favor of the free-enterprise system.

**Coalition for a Prosperous America**
1200 G St., N.W., Washington, DC 20005
202-688-5145
www.prosperousamerica.org/
Think tank that promotes an overhaul of U.S. trade policy.

**Economic Strategy Institute**
1730 Rhode Island Ave., N.W., Suite 414, Washington, DC 20036
202-213-7051
www.econstrat.org/
Research organization that favors more transparent and open markets in international trade.

**International Monetary Fund**
700 19th St., N.W., Washington, DC 20431
202-623-7000
www.imf.org
Institution established by 1944 Bretton Woods conference that works for global monetary cooperation, financial stability and global trade.

**International Trade Administration**
U.S. Department of Commerce, 1401 Constitution Ave., N.W., Washington, DC 20230
202-482-3809
www.trade.gov
Commerce Department office that helps coordinate trade matters and provides studies and data on trade.

**Office of the United States Trade Representative**
600 17th St., N.W., Washington, DC 20508
202-395-3230
https://ustr.gov
White House agency responsible for coordinating U.S. international trade, commodity and direct investment policy and overseeing negotiations with other nations.

**Peterson Institute for International Economics**
1750 Massachusetts Ave., N.W., Washington, DC 20036-1903
202-328-9000
https://piie.com
Think tank focused on international economic and trade issues.

**U.S. International Trade Commission**
500 E St., S.W., Washington, DC 20436
202-205-2000
www.usitc.gov
Federal agency established in 1916 as the U.S. Tariff Commission; gathers and analyzes trade data and provides trade expertise to Congress and the president.

**World Trade Organization**
Centre William Rappard, Rue de Lausanne 154, CH-1211 Geneva 21, Switzerland
+41 (0)22 739 51 11
www.wto.org
Intergovernmental organization that regulates international trade.

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