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# Backtracking from Globalization

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## Abstract

This paper offers a global perspective of the political economy of the liberal trading system since the Great Depression and examines four major intellectual and socio-political challenges facing international trade and globalization going forward, including: (1) income redistribution, (2) the rise of Asia and a potential shift in comparative advantage, (3) the rise of China and the national security argument, and (4) the lack of compelling dynamic evidence supporting free trade. Given the growing domestic and global discontent with free trade, and the fact that these exacerbating issues remain, this paper suggests that U.S. and global trade policies may shift away from the liberal trading system.


**KEYWORDS:** globalization, international trade, protectionism

## I. Introduction

As the global economy went into recession in 2008 there were many attempts in the United States and elsewhere to use protectionist measures of one sort or another to boost domestic output and/or prevent domestic stimulus spending from leaking abroad. Simon Everett of the Center of Economic Policy Research (CEPR) formed a special research group, the Global Trade Alert to monitor protectionist measures stemming from the crisis. The CEPR report concludes "the overwhelming picture is one of planned and implemented state initiatives that reduce foreign commercial opportunities and reverse the 25-year trend towards open borders" (Everett, 2009, p. 3). The U.S., according to Everett is among the worst of the G20 offenders. Among other anti-trade policies, the U.S. has raised new tariffs on Chinese tires, cancelled a program allowing Mexican trucks to carry cargo on American roads, and enacted a stimulus package that included explicit "buy-America" requirements.

The response to these measures from academia and the mainstream press was mostly critical—these policy initiatives were thought to be misguided. The theory of comparative advantage and the lessons of the Smoot-Hawley Tariff Act of 1930 clearly demonstrate that free trade is better than protectionism (Irwin, 1996a). In addition to its economic benefits, trade promotes harmonious relations among states.[1] In his May 2010 National Security Strategy, President Obama restated the national interest in open markets:

> The success of free nations, open markets, and social progress in recent decades has accelerated globalization on an unprecedented scale. This has opened the doors of opportunity around the globe, extended democracy to hundreds of millions of people, and made peace possible among the major powers. (p. 1)

Most mainstream economists would agree with President Obama's statement above[2], but the intellectual, empirical, and popular political support[3] for

[1] The Universal Economy Doctrine literature dates back to ancient writers and states that trade increases the cost to governments of waging war. Litanies declared in his fourth century Orations (III), "God did not bestow all products upon all parts of the earth, but distributed His gifts over different regions, to the end that men might cultivate a social relationship because one would have need of the help of another. And so He called commerce into being, that all men might be able to have common enjoyment of the fruits of the earth, no matter where produced." Frederic Bastia bluntly states "When goods cannot cross borders, armies will." Mansfield (1994), Here *et al.* (2009) and Findlay and O'Rouke (2010) provide excellent background and evidence of the Universal Economy Doctrine.

[2] See Bhagwati (2009) and Salvatore (2009) for recent rebuttals to skepticism about the liberal trading order.

free trade in the United States and elsewhere seems to be weakening and to assume that the old arguments are good enough to keep the forces of protectionism at bay is wishful thinking. An interesting illustration of this trend occurred when the Institute of International Economics published Rodrik's (1997) manuscript *Has Globalization Gone too Far?* Free trade continues to remain controversial in the eyes of many people, as mentioned by Stiglitz (2002), and many countries routinely restrict international trade for various reasons.

The purpose of this paper is to discuss some of the growing hurdles that the liberal trading system may encounter in the future, especially from a U.S. perspective. This paper suggests that there are four main areas researchers and scholars will need to address regarding the long and short-run consequences of international trade. They include: (1) the distributional impacts from expanded trade, (2) the rise of Asia and the potential shift in comparative advantage, (3) the national security argument, and (4) the weakness of empirical evidence linking trade to U.S. economic growth. Given that these four major issues remain unresolved, especially in the eyes of the public, this paper suggests that U.S. and global trade policies may shift away from free trade in the next several decades.

This paper proceeds as follows: section II briefly discusses United States and global historical trading policies, section III reports four main reasons why the free-trade consensus is fraying and will likely continue to deteriorate, and section IV summarizes the shift in political attitudes about trade policy and concludes with our ideas about the future course of U.S. trade policies.

## II. Brief History of Global Trade Policy

### A. Sixty Years of Liberal U.S. Trade Policy

The United States has not always strived to be an exemplar of free trade and globalization. In its early years U.S. policy - spurred by politicians such as Alexander Hamilton and Henry Clay - focused on high tariffs, large subsidies to key industries, and infrastructure investment designed to create an industrial economy for the sake of military and economic power. Frieden (2008, p. 940) states that "The Smoot-Hawley Tariff was the culmination of 150 years of American protectionism, with mild reductions before the Civil War, but a general record of having some of the world's highest trade barriers." The professional economists those politicians looked to for inspiration (especially Adam Smith and John Stewart Mill) after all, had suggested the arguments for national security

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[3] Whaples (2009) reports that 83 percent of economists agree that "The United States should eliminate remaining tariffs and other barriers to trade." This is in sharp contrast with cultural and political reality. Seib (2000) reports that only 38 percent of U.S. residents felt that trade has been "good for the economy."


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intervention (Smith) and infant industry protection (Mill) as well as the case for free trade.[4] The protectionist/interventionist policies seemed to help make the overall American economy strong (Irwin, 1996b), but they also had serious distributional impacts (O'Rourke and Williamson, 2001). High tariffs were a major grievance of the 19th century Southern states and easy immigration shifted returns from labor to capital.[5]

The U.S. moved to a freer-trade stance when that policy became more attractive after World War II. By then the U.S. was economically dominant and an expansion of global markets seemed as if it would be beneficial both economically and geopolitically. Economic theory suggested that comparative advantage and economies of scale would bring economic gains through efficiency improvements. Economic history was also clear: the infamous Smoot-Hawley tariffs led to competitive tariff retaliation, a massive shrinkage in foreign trade and a deepening of the Great Depression, while the Japanese and German regional economic empires of the 1930s helped promote war (O'Rourke and Williamson, 2001). Economic theory never said free trade was good for *all* industries and *all* people, but since the aggregate gains are positive, the winners could afford to compensate the losers and everyone could be made better off.[6]

The U.S. free-trade strategy was also based on political theories and strategies. After World War II trade expansion was seen as a good way to bolster Europe economically, tie it to the West, and strengthen the West against the Soviet Union. The U.S. spurred the creation of the GATT/WTO in an effort to bring all countries into a democratic rule-based system under the assumption that trade would help all countries prosper under U.S. leadership (Irwin, 1996b). Since 1980 or so, the U.S. has tried to lure China into the world market system to foster interdependence and peace. After the fall of the USSR faith in free markets was never greater. There was a "Washington Consensus" on growth and a global push for trade reform leading to the establishment of the WTO in 1995 and large new plans to extend trade liberalization to more countries and more goods and services.

[4] See Irwin (1996b) for a discussion of Smith and Mill and the intellectual underpinnings of the 19th century trade policy debate. Irwin also cites Alfred Marshall and Frank Taussig on the benefits of infant industry protection for the United States.

[5] See Eckes (1995) and O'Rourke and Williamson (2001) for a more thorough discussion of U.S. trade policy in the 19th and early 20th centuries.

[6] Unfortunately, compensating the losers from expanded trade has never been easy or satisfactory. Direct subsidies, job-training, and extended unemployment benefits have not been enough to overcome the perception that trade has disadvantaged substantial groups of Americans. Rosen (2008, p. 8) finds that "efforts to assist workers adversely affected by increases in imports and shifts in production have remained modest at best."

**B. Recent Non-U.S. Experiences with Trade Policy**

The global post-War record should be considered a great success. Rapid recovery from the horrendous damage of World War II in Europe and Japan resulted in sustained high per-capita economic growth in the OECD countries, and high average economic growth in the non-Communist, non-OECD countries. There was a huge decline in global poverty as reported in Besley and Burgess (2003) and there were no great-power wars—one of the main goals of the post-war liberal order fostered by the United States. Resistance to that order is growing, however, (see Stiglitz (2002) for example) and most critics argue that these figures speak of averages, and that the benefits have not been evenly distributed—either among countries or within countries. Also, many East Asian countries soared after a shift to market economics, but it has been suggested that they profited not from *freer* trade, but from export-led growth and high protectionism (Lawrence and Weinstein, 1999).

The results for Sub-Saharan Africa are at the opposite end of the spectrum with per capita GDP growth close to zero for many of these countries. The poorer regions export mostly primary products, natural resources, intermediate goods and people, because they do not produce the kinds of goods and services the world demands and those that form the basis for modern economic growth. Development theorists now blame Africa's core problems on the weakness of their institutions, see Knack and Keefer (1995), DeSoto (2000), Easterly (2002), but globalization, or lack of it, is also a problem. Africa is held back by agricultural protectionism in the OECD countries and it is disadvantaged by China's success (Collier, 2007). China still has hundreds of millions of people in its primitive sector, making it difficult for poorer countries to get started in low-wage manufacturing. In addition, trade liberalization can have negative impacts by reducing native industries. Theory says resources will flow to more efficient uses, but the theory does not seem to apply when governments and markets do not work well.

Bitterness in much of Latin America and South America about "neoliberalism" is causing a shift to the political left, to populism and to more state intervention, especially in Venezuela, Ecuador, Peru, Argentina, Nicaragua, and El Salvador. Chile, Brazil, Mexico, and Colombia are still hanging on to neoliberal policies, but the debate over these issues there is intense. There is a growing perception in the South that the global trade regime is unfair, unhelpful, and that it causes poverty, not wealth (Ocampo, 2004).

China profited from globalization, but Beijing is trying to change the rules now. Bergsten *et al.* (2006) accuses China of destabilizing the system through exchange rate manipulation, disinterest in further global liberalization, and an


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emphasis on bilateral, politically-oriented FTA's in Asia aimed at reducing U.S. influence.

## III. Consensus Frays in the United States

Support for globalization worldwide, according to Andrew Kohut, President of the Pew Research Center, is clearly headed in a negative direction, and "the ebbing of enthusiasm has been particularly dramatic in the United States" (Kohut and Wike, 2008, p. 70). The most recent reports from the Chicago Council on Global Affairs (2010a, 2010b) confirm the trend. On question 10 of its survey compiled by Knowledge Networks, 56% of respondents agreed with the statement that "increasing connections of our economy with others around the world is mostly good for the United States (2010b, p. 18) down from 58% in 2008 and 64% in 2004. Perhaps even the 56% figure is too high. In the same 2010 survey only 46% of respondents agreed with the seemingly similar statement "Overall, do you think globalization is good for the US economy" while 50% said that it was bad (2010b, Question 75/1, p. 49). Scheve and Slaughter (2006) also cite a negative trend in support for free trade, and claim that anti-trade opinions do not simply reflect ignorance about the subject:

> The U.S. evidence is that large majorities of individuals acknowledge that trade generates the benefits that economic theory predicts. Similarly large majorities also worry, however, that trade generates labor market costs in terms of job destruction and lower wages. (p. 220)

The recent Chicago Council survey supports that argument too. On Question 70 of the 2010 poll, 36% flatly oppose agreements to lower trade barriers, while 43% condition their support of lower trade barriers on government programs to help displaced workers.

The 2008 U.S. political campaigns included more anti-trade talk than most elections in recent decades, including rhetoric about opening existing trade treaties for renegotiation. Renewal of fast-track negotiating authority for new free trade arrangements is not likely in the current Congress, even if the administration wanted it. Furthermore, already-negotiated free trade deals have little promise of passing Congress and momentum is slow on negotiating new ones. Recently, support for free trade has diminished across the political spectrum. Dan Griswold, Director of Trade Policy Studies at the Cato Institute, who manages an on-line data base on Congressional voting patterns has found that: "For decades after World War II, support for trade agreements was strongly bipartisan. The most striking trend in congressional voting on trade in recent years has been the plunge in support for free trade among House Democrats" (Griswold, email to lead author, 22 July, 2010).

This article focuses on four main issues facing the continuation of a liberal U.S. trade policy:

## 1. Income Distribution

In this section we examine a somewhat popular proposition made by opponents to expanded trade that growing trade in the U.S. with the rest of the world has been responsible for a corresponding increase in U.S. income inequality. Theory has always told us that, in the U.S., the scarce factor of production (labor) could lose under expanded trade, but early empirical studies by Borjas *et al.* (1991), Krugman (1995) and others indicated that trade accounted for only about 20% of the increase in inequality, skill-biased technical change leading to higher returns to education accounted for the rest (Lawrence, 2008). However, those studies were based on data from the 1970's and 1980's when most U.S. trade was North-North. Some more recent studies that employ data covering a period with much more North-South trade, suggest a much more negative impact on the wages of low-skilled U.S. workers due to the growth in trade, see for example Feenstra and Hanson (2001) and Krugman (2008). Also using the recent data, however, Lawrence (2008) still concludes that the impact of trade on U.S. real wage differentials has been modest. Krugman (2008) has suggested that data limitations may continue to hamper the empirics behind this debate and that more research needs to be done.

Whatever the cause of the rise in inequality, the average real hourly wage of production and nonsupervisory workers has been stagnant since 1980 and it has lagged the growth in real GDP per capita (ERP, 2009, p. 340). Nevertheless, it is *perception*, not economic analysis and data that matters at the polls. Workers in trade-affected U.S. manufacturing industries, along with other groups, have not waited for economists to tell them they have been hurt. They have reacted at the polling booth and by increasing their pressure on Congressional representatives to oppose free trade legislation and to put up new barriers to trade. Scheve and Slaughter's (2001) survey shows that low-skilled workers are the most skeptical of the benefits of free trade. In addition, the gathering evidence cited by Krugman (2008) and others suggests that anti-trade pressure from these workers will grow.

## 2. Rise of Asia and the Theory of Comparative Advantage

Samuelson claimed in 1972 that the aggregate gains from trade are not necessarily positive. He expanded on this idea in his (2004) paper, "Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting


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Globalization," saying that growth in the rest of the world can hurt a country if it takes place in sectors that compete with its native exports—where it has comparative advantage. Relative, and even absolute, per capita GDP can fall in such a situation.

Gomory and Baumol (2000, 2009), have extended this work and show that in a modern (as opposed to a Ricardian) free-trade world, "there are many possible equilibria with vastly different outcomes for the countries involved" (2009, p. 549). They state, "It is perfectly possible—indeed common—for a country's equilibrium trade outcome to be less than this autarky outcome" (2009, p. 544). "In the modern world", they say, "good equilibria more often are created rather than bestowed by nature. As such, there is much that countries can do to affect their trading outcomes" (2009, p. 549).

Many economists tend to dismiss these ideas. Bhagwati (2009) argues that Samuelson's exposition cannot possibly be used as a justification for U.S. protectionism and that the Gomory and Baumol argument is pointless because the U.S. could not devise effective industrial policy to remedy it, even if it were true. Krugman and Obstfeld (2009, p. 98) state, "…it's an empirical question whether the growth of newly industrialized countries such as China has actually hurt advanced countries. And the facts don't support the claim." The theoretical possibility still exists, however, and the current Chinese government is acting as if it believes the argument.[7] It continues to employ active trade policies to push its industries up the value chain, aiming explicitly at sectors such as wide-body aircraft that have been the mainstay of U.S. industrial pre-eminence. Samuelson says, "economic history is replete with examples like this, first insidiously, and later decisively", pointing explicitly to British manufacturing being overtaken by U.S. industry after 1850.

Samuelson's argument made it into the 2008 presidential campaign when Hillary Clinton said, "I agree with Paul Samuelson, the very famous economist, who has recently spoken and written about how comparative advantage, as it is classically understood, may not be descriptive of the 21st century economy in which we find ourselves" (Financial Times, December 3, 2007, p. 1).

## 3. The Rise of China and the National Security Argument

The U.S.-China Economic and Security Review Commission is an organization chartered and funded by the U.S. Congress and dedicated to the proposition that China poses a multifaceted threat to the U.S. The Commission notes Chinese mercantilism and the comparative advantage issue described in section 2 above, but it focuses mainly on the national security argument. The threat perceived by

[7] So did the U.S. government in the 19th century.

defense analysts is that a decline in the U.S. manufacturing sector, and a subsequent decline in the U.S. industrial base, could hamper the domestic production of weaponry in time of war. The U.S. still has big, profitable defense firms, such as Lockheed, Raytheon, and Boeing, to name a few—but they are becoming systems integrators that rely on outsourced production, much of it outsourced to China. The Commission launched a major study in 2007 (USCC, 2007) to quantify how many components of 3 major weapon systems were imported and to determine where the imports came from. The research was inconclusive—the Chinese contribution was probably large and growing over time—but the supply chains are too complicated to fully unravel—itself a worrying conclusion. This dependence on potentially hostile nations for critical defense materiel has led the Commission, every year since 2000, to recommend steps to counter defense outsourcing with proposals that include import barriers, subsidies to domestic producers, and the creation of government-owned manufacturing plants. These recommendations have had little impact yet but their arguments gain strength every time there are new reports of Chinese quality deficiencies, or outright Chinese aggressiveness, as in the 2007 cybertheft of U.S. military technology and more recent revelations of probable Chinese insertion of malicious software code in the U.S. energy grid (USCC, 2009). Bringing China into the global trading system was supposed to promote harmonious interdependence. Instead, USCC argues it has empowered the Chinese economically, politically, and militarily without turning the country into a friend and ally. Our fear of them as a strategic rival and our sense of vulnerability is growing, see Kugler (2006). Polling data (CCGA, 2010b) shows that large and growing majorities of Americans think that China pursues unfair trading policies, in contrast to more favorable attitudes toward the EU, Canada, Japan, and Mexico.

## 4. The Dynamic Case for Free Trade is Far from Complete

Economists have made a case for free-trade by developing theoretical models and by estimating the welfare gains from reducing or eliminating barriers to trade. Studies from Krugman (1979) and Broda and Weinstein (2006) also suggest that trade benefits society through gains in overall quality and variety. However, the standard static growth arguments in favor of free trade leave trade-promoters quite vulnerable.

The often-used static models only consider the short-run partial equilibrium efficiency gains, and the calculated Harberger estimates are usually unimpressive. The static models suggest that the gains from trade range between 0.5 to 2 percent of GDP, see for example, Wall (2000) who extends Hufbauer and Elliott's (1994) classic study to find the net welfare loss from protectionism in the


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United States in 1996 to be roughly $100 billion, or 1.45 percent of GDP. Further, these studies use comparative static analysis and cannot shed much light on growth dynamics.

Many studies have tried to estimate the impact of trade liberalization using cross-country regressions. In a recent study, Bradford *et al.* (2006) use a cross-OECD regression to claim that the 2005 U.S. economy was between $800 billion and $1.4 trillion larger than it would have been without post-War trade liberalization.[8] Baldwin (2003), Lewer and Van den Berg (2003), and Irwin (2005) by and large support the idea that trade is pro-growth, but there is much methodological dispute over whether these cross-country regressions tell us much about causality. Specifically, Rodriguez and Rodrik (2001) argue that international trade policy is so closely correlated with many other economic policies (such as regulatory policies, education policies, legal systems, and forms of government, etc.) that it is impossible to differentiate between trade's effect on growth and the growth effects of those other policies. In fact, they suggest that economic growth probably depends more on those other policies than it does on trade policy. Rodrik *et al.* (2002) report that trade is an insignificant variable in their growth equation (that includes a number of additional institutional factors). Rigobon and Rodrik (2004) show that econometric methods that compensate for simultaneous effects find that in the presence of other institutional variables, their openness variable actually has a *negative* impact on income levels. Lee *et al.* (2005) use the same method with a different model and find trade's influence on growth is positive, but well below the earlier estimates discussed above. It should be noted that three of the most prominent economists who have tried to decompose the sources of post-war U.S. economic growth have either dismissed trade as insignificant (Denison 1967, 1974, 1985 and Kendrick, 1981) or failed to mention it altogether (Jorgenson, 2005).

There is also a troubling disconnect between the economic growth literature and the trade literature. Charles Jones, in the *Handbook of Economic Growth* (2005, Vol. 1B, Chapter 16), nowhere mentions trade. He does state that "80% of U.S. growth in the post-war period is due to transition dynamics associated in roughly equal parts with educational attainment and with increases in world R&D intensity." Only about 20% of U.S. growth is attributed to the scale effect associated with population growth in the idea-generating countries" (p. 1102). Grossman and Helpman (1991) explained how trade can help or hurt innovation and thus growth, but empirical explorations of these ideas are still lacking. Acemoglu's (2009) theoretical models of trade and growth leave the issue undecided: "Since there are models that highlight both the positive and

[8] This implies that average U.S. GDP growth is only roughly 0.2 percent higher, 1946-2005, than it would have been without trade liberalization.

negative effects of trade on growth, the debate can be resolved only by empirical work" (p. 683).

The dynamic case for free trade is potentially a strong one, but as Lewer and Van den Berg (2007) point out, further advances in dynamic modeling and additional empirical investigation are required to validate the argument. Advances that establish linkages between trade-and-technology (Feenstra *et al.*, 2009) and trade-and-institutional-quality will be particularly relevant going forward.

## IV. Conclusions and the Future of U.S. Trade Policy

We know from the work of Kaempfer *et al.* (2003) that trade policies, while often rooted in interest groups scrambling for distributional gains, can also be related to national interest calculations—whether economic or security related. In the past pragmatic national interests have pushed in both directions. In the early history of the United States, Alexander Hamilton (1791) promoted infant industry protection to spur the growth of the economy and George Washington wanted the country to be able to produce its own weapons (Eckes, 1995). In the post World War II period, on the other hand, liberal trade policies were assumed by both Democratic and Republican administrations to promote foreign policy and national security considerations (Kaempfer *et al.*, 2003). Liberal trade policies were justified as efforts to improve national economic prosperity by enhancing economic efficiency and by fostering harmonious foreign relations. The inevitable scrambling by various interest groups for protection was held in check not just by interest rivalry but also by a consensus on the pro-growth and pro-harmony aspects of a liberal trade policy.

We have presented evidence that the U.S. consensus in favor of a liberal trade policy is weakening—evidence in the form of opinion polls, in data from Congressional votes, in statements by respected observers such as Eichengreen and Irwin (2007), and in the worried responses by prominent defenders of that order such as Bhagwati (2009) and Salvatore (2009). In addition, we have shown that four major factors may combine to help tip the balance. First, there is a growing perception that trade (along with capital mobility and immigration) has had an adverse impact on incomes and income distribution. The growing anxiety over incomes and job security probably goes a long way to explain why Congressional support for free trade has been declining. Second, the orthodox economic arguments do not seem to be as persuasive to many as they used to be. Paul Samuelson's (2004) article provoked a furious reaction among academics but it remains influential among economists and politicians alike. Many economists agree with Krugman and Obstfeld (2006) who assert that the Samuelson argument does not seem to have empirical validity and would not justify a protectionist


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response even if it did. But Krugman and Obstefeld also say that "economic theory does not provide a dogmatic defense of free trade, something that it is often accused of doing" (p. 217). Third, the national security arguments in favor of somehow containing a perceived China threat will continue to grow in salience if China's economy and military power continue to grow. Fourth, we have also pointed out that the dynamic models of trade and growth are neither conclusive nor compelling and that the empirical work linking trade to growth leaves much to be desired.

So what happens next? We do not pretend to know, but unless income and income-security fears are addressed by effective economic policies and a stronger social welfare net designed to reduce the perception that the American worker will be the loser in a freer-trade world, and unless economists can provide more compelling evidence on the benefits of expanding the current trade regime, we fear that American support for the liberal trading system may weaken further. Nobody is going to say, "Smoot-Hawley was a really good idea, let's raise tariffs by 100 percent", but we could expect to see policy changing on many fronts, including: more subsidies to domestic industries, more aggressive responses to WTO judgments, greater energy in the Committee on Foreign Investment in the United States (CFIUS)[9] process, an enlarged and invigorated International Trade Commission (ITC)[10] pursuing many more anti-dumping cases, greater resistance to illegal immigration or immigration in general, and greater efforts to curb foreign industrial espionage.

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[9] The Committee on Foreign Investment in the United States (CFIUS) refers to an inter-agency committee that reviews on national security grounds foreign investment in U.S. companies or operations.

[10] The International Trade Commission (ITC) is an independent agency of the U.S. government charged with investigating unfair foreign trade practices.

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