



Inaugural Issue

Does Trade Policy Matter?

By Philip I. Levy

As hard as it may be, it is worth trying to reinvigorate the global trade environment. Public opinion is skeptical, and the political obstacles are substantial, but the benefits of a revitalized trade system strongly outweigh the drawbacks. Resting on our trade laurels not only would forego future gains, but would threaten the trade gains of the postwar era that we currently enjoy. This Outlook launches a new series on international economic policy issues. It is part of AEI's new Program in International Economics.

Who really cares what trade policy we adopt anyway? Ever since the end of the Second World War, at the urging of economists, the major trading nations of the world have been chipping away at trade barriers. Tariffs have fallen, and trade has flourished. What difference will it make if we pass the Colombia Free Trade Agreement or reach yet another global accord in Geneva? Will we reach a point at which we have done enough and can turn to other concerns and simply enjoy the gains we have made?

This question has become more pressing as public support for trade has waned, as trade has become a contentious issue in the U.S. presidential campaign, and as efforts to attack remaining trade barriers have faltered. The Pew Research Center recently documented the sharp decline in public regard for trade in the United States. According to pollsters Andrew Kohut and Richard Wike, the percentage of survey respondents in forty-seven countries saying trade is good was lowest in the United States. In the thirty-five countries for which 2002 attitudes could be compared to 2007 attitudes, the United States also experienced the sharpest drop, from 78 percent to 59 percent.¹

Philip I. Levy (philip.levy@aei.org) is a resident scholar at AEI.

This surely helps account for the emergence of trade as a topic in the presidential campaign. In the Democratic primaries, Senators Barack Obama and Hillary Clinton vied with each other to see who could object more vehemently to the North American Free Trade Agreement (NAFTA). The magnitude of the political shift is clear, since it was President Bill Clinton who concluded the NAFTA negotiations and oversaw its implementation. Not only has the president's trade negotiating authority expired, but amidst a partisan fight in April over the Colombia Free Trade Agreement, Speaker Nancy Pelosi also revoked Congress's commitment to vote up or down on negotiated agreements in a timely fashion.²

This summer, the trade ministers of the World Trade Organization (WTO) member states gathered for a marathon push in Geneva to try to agree on a global trade liberalization package. The meeting was the latest in the series of talks that commenced in late 2001 in Doha. Previous ministerial meetings had failed, although perhaps none as spectacularly as the latest in Geneva. It was notable both because it veered tantalizingly close to success before it crashed and because it will be so difficult to resume the talks. The United States is about to get a new administration, and there

may soon be trade leadership changes in Europe, India, and the WTO. The failure laid bare fundamental conflicts over the appropriate role of major developing nations in the trading system as well as the difficulties of striking agreements with over 150 nations pressing their interests.

In sum, it is hard to liberalize trade right now. But the question remains: is it really worth fighting a tide of public opinion, working through political thickets, and attempting to lead an international push to reinvigorate a global trading environment?

Some authors have argued that it is not. *Washington Post* economic columnist Sebastian Mallaby wrote in June that the presidential candidates' stances on trade mattered little when assessing what they might do for economic growth:

Today most trade barriers have been removed; although the remainder certainly ought to be abolished, there's not much prospect of that because the Doha trade talks have stalled. Provided that Obama finds a way of crawling back from his embarrassing talk of reopening NAFTA, the gap between his trade views and (Senator John) McCain's doesn't much matter.³

Harvard Kennedy School economist Lant Pritchett, in a February interview with *Reason* magazine, said, "Relative to when I started working as a trade economist in the early 1980s, the world is completely liberalized. So the incremental gains from anything that could happen as a result of WTO negotiations are just infinitesimal."⁴ He was not opposing trade liberalization, just arguing that we should focus on barriers to migration instead.

Mallaby and Pritchett are right that we have come a long way, but they make two strong presumptions—that there are few gains left to be had from trade liberalization and that it will be easy to retain the gains we have already made. Both are questionable.

Trade's Turbulent History

As we look with awe at the wonders of the modern economy—in which we eat Chilean grapes, send office work to India, and zip around the world in American-made jets—it is tempting to think that we are at the endpoint of a long, inexorable march to globalization. Consider, though, the famous passage of John Maynard Keynes's 1919 *Economic Consequences of the Peace*, in

which he reflected on the time just before the First World War:

The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages.⁵

According to WTO trade statistics, world trade made up roughly 8 percent of world output in 1913. By 1950, that figure had fallen to 5.5 percent.⁶ This was due in part to the disastrous effects of the world wars, of course, but the erection of global barriers to trade in the 1930s played a significant role as well.

The latest woe-begotten round of Doha trade talks was intended to address the concerns of developing nations. It has foundered, however, in large part because of a persistent disagreement over whether or not large developing nations like Brazil, India, and China should play a full role.

The progress in trade liberalization over sixty years of global trade talks has been remarkable. In terms of merchandise trade volumes, trade in 2005 was twenty-seven times trade in 1950. Over the same period, world output increased to eight times its initial level. The comparison shows both the growing importance of trade and the beneficial effect on the world economy.

This boom in trade was something of a surprise, even to some trade specialists. In the period between the world wars, one school of thought held that the importance of international trade was sure to diminish.⁷ Proponents argued that trade had been driven by differences in the level of development between more advanced nations—Europe—and the new up-and-comers—the United States, for example. Once the United States had the same technology and skills of its European partners,

why bother sending the same goods back and forth across the Atlantic?

As it turned out, there were great gains to be had by producing Volkswagens in Germany and Chevrolets in Michigan, even when both countries were perfectly capable of making cars. This specialization increased when manufacturers were able to produce an engine in Brazil, a chassis in Canada, and onboard electronics in Japan. The question was not whether a product would be made in one country or another, but how best to distribute production so as to make the products competitively.

There were several broad trends that facilitated this growth in trade. In 1947, twenty-three countries reached the General Agreement on Tariffs and Trade (GATT). This was the first of eight rounds that steadily lowered trade barriers. In the 1940s, average industrial tariffs among advanced countries were estimated to be in the 20–30 percent range. After the Uruguay round in the 1990s, these average industrial tariffs were roughly 3 percent.⁸

The arguments for resting on our trade laurels assume that such a pause is feasible and that in the absence of trade liberalization progress, we still get to keep what we have accomplished so far.

The expansion of trade also benefited from advances in transport and communication. A study by Purdue University's David Hummels argues that the increased use of containers in shipping lowered shipping costs by as much as 13 percent and that the cost of air freight dropped by a factor of ten from 1955 to 2004. By 2000, more than half of the value of U.S. exports moved by air.⁹ With the introduction of the Internet, expensive international telephone calls have been replaced with costless e-mails.

All of these forces together—policy, transport, and communications—paved the way for trade's enormous expansion in the latter half of the twentieth century. The benefits of that expansion have been equally impressive. It is difficult to estimate the gains precisely, but one careful estimate by researchers at the Peterson Institute for International Economics found that Americans are roughly \$1 trillion per year better off as a result of the integration that has taken place.¹⁰

The same researchers estimated that the removal of remaining barriers to trade could deliver an annual payoff to the United States of roughly \$500 billion, or about \$4,500 per American household. That seems to contradict claims that the gains from trade liberalization have been exhausted and that trade policy has become irrelevant. With all the progress that has been made in trade, what is left to be done?

Remaining Challenges

There are important countries and sectors into which the postwar liberalization did not reach. Consider India as an example. In 1948, India's average applied tariff on vehicles was 26 percent. By 1987, it had risen to 70 percent. It fell back to 37 percent by 2001.¹¹ This is emblematic of the limited role that developing countries played historically in the GATT. While there have been developing country members since the inception of the GATT, they have been largely free of obligation to engage in the back-and-forth of trade negotiations.¹² On the misguided principle that countries need to protect their markets in order to develop, the developing nations were supposed to receive special treatment; other countries' tariff cuts would be extended to them without any demand for reciprocal opening. Because global trade talks are really a grand bazaar in which countries make mutually beneficial swaps, developing countries largely got what they paid for—very little.

The latest woe-begotten round of Doha trade talks was intended to address the concerns of developing nations. It has foundered, however, in large part because of a persistent disagreement over whether or not large developing nations like Brazil, India, and China should play a full role. In the immediate postwar years, it may have been possible to write off these countries as economically trivial; it is not possible anymore.

The GATT progress described above was in manufactured goods trade among developed nations. Much less progress has been made in lowering barriers to trade in agricultural goods. The recent world food crisis was worsened by actions of some major exporters who blocked trade in order to keep domestic prices low. This is but one example of the need for an active policy and a forum to address new and emerging trade concerns. In the same way that seers of the 1930s could not foresee the burgeoning intra-industry trade of the 1960s, it would have been very difficult in the 1960s to predict the need for the WTO's Information Technology Agreement in the 1990s.

There is already such a glaring unmet need on the global agenda in the treatment of services and investment. While the United States runs a large global trade deficit in goods trade, it has run a steady surplus in services (almost \$120 billion in 2007).¹³ Services exports include travel, engineering, investment banking, and insurance. Of course, these are hardly the kinds of exports that can be stuffed in a container and shipped. They often require providers to enter or be based in other countries and are often regulated.

In fact, even trade in manufactures can be heavily dependent on U.S. investments in other countries. According to the U.S. Census Bureau, in 2007, over 40 percent of U.S. goods trade was between “related parties”—a U.S. subsidiary shipping to a foreign parent or a foreign subsidiary shipping to a U.S. parent.¹⁴ Regulations governing investment can therefore have an important impact on U.S. trade performance. Yet WTO progress has been skimpy on services and inadequate on investment.

Despite the progress on industrial tariffs, there are ample additional gains to be had through coordinated trade liberalization. This progress in new sectors becomes even more important as rising energy costs and vibrant new markets have driven up the cost of shipping, thereby undercutting some of the gains from liberalization that we had already taken for granted.

Can We Stand Still?

The arguments for resting on our trade laurels assume that such a pause is feasible and that in the absence of trade liberalization progress, we still get to keep what we have accomplished so far. This flies in the face of the long-popular “bicycle theory”: trade liberalization is like a bicycle; you must keep moving forward or you fall over. The question is whether there is any basis for this theory or whether it is just a catchy but empty metaphor.

The gains to date are actually less solid than they appear. One of the accomplishments of the Uruguay round that concluded in the 1990s was to replace the disembodied GATT with a real institution to govern trade—the WTO. This gave casual observers an impression of solidity. That impression was reinforced whenever countries would explain the removal of a popular but trade-distorting measure with the claim that the WTO made them do it. One could imagine a WTO Marshall Force ready to sweep in and enforce edicts, just as controversial Supreme Court verdicts in

the United States are backed by the might of the federal government.

But no such WTO force exists. The WTO oversees a set of agreements among member countries. It helps administer those agreements with a “dispute settlement mechanism.”¹⁵ At first blush, these dispute settlement panels look a lot like courts. There are even appellate bodies, continuing the parallel. But there is a crucial difference in function: at the WTO, countries do not have to comply if they do not want to.

If a country argues that the United States has not met its obligations under the WTO’s trade agreements, a panel of impartial experts will convene to determine whether the complaining country has a point. If they find the United States to be in the wrong, the United States has some choices to make. It can change its policies to make the complaining country happy, or it can decide to leave its policies as they are. In that case, the panel would likely authorize the complaining country to retaliate against the United States in a limited way to settle the score.

Without progress on trade negotiations, it is entirely plausible that countries would opt for political expediency rather than for supporting the trading system. This could threaten the substantial gains of the postwar era.

When heavyweights like the United States and Europe clash, as they have over issues like genetically modified food and tax policy, they are each so large that the threats of retaliation are enough to encourage compliance. But what happens when a bantamweight country takes on one of the heavy hitters? Remarkably, the heavyweights have usually consented to change their policies as the WTO panel suggests.

Why do they do this? Why abandon popular policies in the face of empty threats? The most likely answer is that the heavyweights see value in the WTO as an institution. They know that if they exercise their rights to ignore panel rulings, the WTO will be diminished and will be less valuable for addressing important concerns about the trading system. That implies a link between prospects of future progress at the WTO and willingness to adhere to agreements already struck. If the world were to take a pause in trade liberalization, the pressures to ignore unpopular rulings could mount.

Unpopular rulings would also become more likely. With the present world trading system, countries have a choice in how they pursue their concerns: negotiation or litigation. If negotiations are not available, litigation becomes more likely. This effect has already begun with cases like Brazil's successful complaint against U.S. cotton subsidies.

Without progress on trade negotiations, it is entirely plausible that countries would opt for political expediency rather than for supporting the trading system. This could threaten the substantial gains of the post-war era.

The Importance of Trade Policy

This summer's breakdown of the WTO Doha talks showed just how difficult it will be to keep the system moving forward. The WTO has both exploded in size and adopted a consensus approach that requires agreement among all members. Reaching consensus has become increasingly difficult. It is clear, though, that if there is to be progress, American leadership will play a significant role. Given America's economic heft and its traditional role in trade talks, it is highly unlikely that much will happen if the United States decides to be a passive bystander.

Furthermore, the United States has the potential to destroy any hope of WTO progress if it does not take great care in the crafting of its trade policy. A major domestic point of contention on trade has been whether or not binding labor and environmental clauses should be part of trade agreements. Proponents of their inclusion, often Democrats, have taken heart from the willingness of countries like Jordan and Peru to sign trade agreements with the United States that included these clauses. In global trade talks, however, developing countries perceive these measures to be thinly veiled protectionism. If strong labor and environmental measures become prerequisites for deals with the United States, the only willing partners will be those small countries for whom the seal of approval that a deal confers outweighs concerns about the externally imposed measures.

The challenges at the WTO are sufficiently daunting that it may take a creative and broad trade strategy to overcome them. This could involve restructuring the talks so that groups of countries could reach agreement without the consensus of all members. It could involve using bilateral or regional trade agreements both to pioneer

new approaches in areas like services and investment and to cement alliances of like-minded countries that can cooperate in bolstering the multilateral system.

None of this will be possible unless American anxieties about trade are addressed through stronger programs for education, retraining, and a better social safety net. The unpopularity that emerged in the Pew polls shows how trade has become a proxy for broader American concerns about job loss and change. Economic studies consistently show that trade plays a relatively minor role in domestic job loss, behind technological change and domestic competition. The U.S. manufacturing sector has led the world in output but has done so with fewer and fewer workers since 1979.¹⁶ This increase in productivity is due to technology, not trade. Similarly, while auto plants have struggled in Michigan and Ohio, they have prospered in Tennessee and South Carolina. It is hard to explain this discrepancy if trade is the driving force because all these states operate under the same trade policy. Yet the temptation to blame trade is enormous, since it is the only one of these factors that can be readily controlled by national policy. The willingness to succumb to this temptation is a key measure of a candidate's approach to trade.

Trade policy has played an unusually prominent role in the presidential campaign to date, and rightly so. It is central to understanding how candidates perceive markets, it is a key part of American leadership in the world, and it is fundamental to preserving and extending the gains from economic growth. There is a dangerously large gap between public perceptions of international trade and the findings of those who study it carefully. This gap either offers an opportunity to play upon public sentiment or an important chance to offer leadership and reconcile the two views. Trade policy still matters.

Notes

1. Andrew Kohut and Richard Wike, "Assessing Globalization: Benefits and Drawbacks of Trade and Integration," Pew Research Center, June 24, 2008, available at <http://pewresearch.org/pubs/879/assessing-globalization-benefits-and-drawbacks-of-trade-and-integration> (accessed September 17, 2008).

2. Carl Hulse, "House Votes to Put Off Trade Deal Bush Sought," *New York Times*, April 11, 2008.

3. Sebastian Mallaby, "The Audacity of Growth," *Washington Post*, June 2, 2008.

4. Kerry Howley, "Ending Global Apartheid," *Reason* (February 2008), available at www.reason.com/news/show/123912.html (accessed September 17, 2008).

5. John Maynard Keynes, *Economic Consequences of the Peace*, 1919.

6. World Trade Organization (WTO) Secretariat, *World Trade Report 2007* (Geneva: WTO, 2007), 244.

7. A. G. Kenwood and A. L. Lougheed, *The Growth of the International Economy 1820–1990*, 3rd ed. (New York: Routledge, 1992), 220.

8. WTO Secretariat, *World Trade Report 2007*, 207, 209.

9. David Hummels, "Transportation Costs and International Trade Over Time," *Journal of Economic Perspectives* (forthcoming).

10. Scott C. Bradford, Paul L. E. Grieco, and Gary Clyde Hufbauer, "The Payoff to America from Global Integration," in *The United States and the World Economy*, ed. C. Fred Bergsten (Danvers, MA: Peterson Institute for International Economics, 2005), 95.

11. WTO Secretariat, *World Trade Report 2007*, 214.

12. T. N. Srinivasan, *Developing Countries and the Multilateral Trading System* (Boulder, CO: Westview Press, 2000).

13. Bureau of Economic Analysis, "U.S. International Trade in Goods and Services, June 2008," exhibit 1, news release, August 12, 2008, available at www.bea.gov/newsreleases/international/trade/2008/pdf/trad0608.pdf (accessed September 23, 2008).

14. U.S. Bureau of the Census, "U.S. Goods Trade: Imports and Exports by Related Parties 2007," news release, May 9, 2008, available at www.census.gov/foreign-trade/Press-Release/2007pr/aip/related_party/rp07.pdf (accessed September 23, 2008).

15. See WTO, "Dispute Settlement," available at www.wto.org/english/tratop_e/dispu_e/dispu_e.htm (accessed September 17, 2008).

16. U.S. Department of Labor, Bureau of Labor Statistics, "Databases, Tables and Calculators by Subject, Employment," available at www.bls.gov/data/#employment (accessed September 23, 2008).