Politics trumps law and economics in U.S. international trade:

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This is a presidential election year in the U.S. and most people expect the election to be a close and bitter contest. It is exceptionally distressing, however, that the current arguments relating to international trade demonstrate little respect for the legal base of the world trading system and clear disregard of fundamental economic principles. As November, 2004 draws closer and the rhetoric becomes even more inflamed, it probably is too much to hope that some legal and economic sense will prevail over the political nonsense currently being propounded. Still, as I mention at the end of this paper, there is some reason for optimism.

The American scene:

- The U.S. economy is doing well, with growth of 4.3 percent for the 4th quarter of 2003 and a forecast growth rate in excess of 3 percent for 2004; but the massive trade deficit in goods and services, $490 for 2003, and sluggish growth in employment offer sharp contrasts to the rosy growth figures. The U.S. government deficit and the long term structural problems with the social security system also add to the concerns about the fundamental health of the U.S. economy.
- Congress plays a very active role in international trade matters.
- The United States is quite evenly divided in political terms, which gives disproportionate powers to special interest groups and key members of Congress.
- International events are perplexing to many Americans, who view the U.S. as a bastion of free trade and open markets. Many Americans also think the assertion of U.S. power in Iraq, Afghanistan and Haiti is justified and humanitarian and they support the Bush Administration's hard line on North Korea. Most Americans do not have a good understanding of how the U.S. is viewed from abroad.

International trade as the villain:

It is easy to conclude that *unfair* trade practices in China, Taiwan and other parts of Asia are the cause of the U.S. trade deficit and the U.S. job losses.

- In 2003, the U.S. had a $124 billion bilateral trade deficit with China. In addition to its huge trade surplus with the U.S., China has a great many other positive indicators: China has attracted nearly $500 billion in foreign direct investment and it continues to sustain one of the highest economic growth rates in the world. In about two decades, China has gone from being an insignificant player in international commerce to where now it is the world's fourth largest exporter and its sixth largest importer, and its foreign exchange reserves are approaching $400 billion, which are the second largest in the world.
- Taiwan, China and other parts of East Asia continue as the most dynamic economies in the world. The U.S. trade deficit with China is the largest, but the

U.S. also has trade deficits with Japan ($66 billion for 2003), Taiwan ($14.1 billion) and all the other countries of East and Southeast Asia, with the exception of Hong Kong, Singapore and Laos, where it has nominal trade surpluses.

- In the American view, one of the more significant unfair trade practices is the manipulation of currencies to keep the US$ overvalued. This makes foreign imports more attractive to Americans and diminishes U.S. export opportunities.
- U.S. politicians and the mass media have loudly condemned the loss of manufacturing jobs to China and other overseas destinations. Most recently, the outsourcing of hi-tech jobs to India and China has made it startlingly clear that the erosion of the U.S. employment base is not limited to less competitive and more traditional industries, such as steel, textiles, and furniture manufacturing. All of the jobs losses, Americans are told, are the result of greedy multinational corporations and unfair trade and labor practices in foreign countries.

The proposed solutions:

The U.S. reactions to the *unfair* trade practices of foreign countries have been remarkably nonsensical and short-sighted, even for an election year.

- Congress has introduced bills to restrain imports, especially from China, with targeted tariffs and quotas. It is not clear, however, how the U.S. can limit imports from China and other specific countries without running afoul of its commitments under the WTO, especially the MFN obligation. There are two other problems with this proposed solution: First, if the U.S. limits goods from China, the most likely effect will be that U.S. imports simply will come from other destinations. Limiting textiles imports from China, for example, will probably lead to increased textile imports from Bangladesh and Indonesia. Second is the very real risk that U.S. import restraints will invite retaliatory measures. Maybe the U.S. policy makers should re-examine the consequences of the Smoot-Hawley Tariff Act in 1930.
- Both Republicans and Democrats are calling for fair trade, not free trade. This anticipates greater use of the U.S. antidumping and countervailing duty laws and more pressure to extend U.S. labor and environmental standards to less developed countries. But the U.S. trade laws already are heavily tilted in favor of protecting U.S. businesses and workers, especially from imports from developing countries, so this solution is almost certain to drive developing countries from the bargaining table of any new multilateral trade negotiations. Essentially, the U.S. is seeking to deny the developing countries their comparative advantage in international trade.
- The Bush Administration and Congress are pressuring China and other East Asian countries to revalue their currencies. This policy is probably close to a real solution, except that so far it has been too focused on China, which is seriously misguided. Instead, the U.S. should be putting much greater pressure on the central banks of Japan, Taiwan, Korea and other East and Southeast Asian countries to get them to limit their intervention in the currency markets.
- Democratic presidential candidate John Kerry has promised to limit the outsourcing of jobs. Despite the inflamed rhetoric, however, the actual proposals have been quite modest – U.S. employers may be required to give 90 days notice of an intention to shift jobs overseas. There also have been threats to take away the tax breaks for companies that use outsourcing. It is not clear, however, what the "tax breaks" are, and, if it is implemented with any degree of seriousness, the only certain effect will be to make U.S. enterprises less competitive in world markets.
- The USTR and the Department of Commerce, along with many other state and federal agencies, are aggressively seeking market opening concessions in other countries. The theory is that if foreign markets are more open U.S. export

opportunities will be greater. Given the range of reactions to U.S. economic problems, this solution is the most responsive and the least likely to do damage to international trade laws and economic principles. The problem is that in the current environment these efforts just confirm the charges of outrageous, blatant hypocrisy: How can the U.S. press foreign countries to open their markets to U.S. goods and services when the U.S. slapped illegal tariffs on steel imports, when in September, 2003, the U.S. insured the collapse of the WTO's Ministerial Meeting in Cancun through its refusal to negotiate on excessive U.S. government subsidies for affluent cotton farmers, even though the subsidies are devastating subsistence cotton farmers in Africa, when the U.S. continues to restrict imports of sugar to benefit a few rich sugar producers in the U.S., even though the poor countries in the Caribbean would benefit greatly from more open access to the U.S. sugar market; and when the U.S. continues its long history of restricting imports of textiles and apparel to benefit a few prosperous textile and apparel manufacturers, even though more open access to U.S. textiles and apparel markets could be an important stimulant for economic growth in the poorest countries in the world? The hypocrisy of the U.S. on trade matters makes it easy for foreign trade ministers to resist U.S. pressures for market opening measures.

The real causes of the economic malaise and some possible solutions:

The U.S.'s $490 billion trade deficit is largely the product of two factors: The abysmal savings rate in the U.S. and the overvalued dollar relative to most Asian currencies. Internally, the U.S. government needs to direct its attention to devices aimed at stimulating the savings rate in the U.S. Is it only a coincidence, for example, that the U.S. has the lowest savings among all of the OECD countries, but it also is the only major industrialized country with no national tax on consumption (such as a value added tax)? On the overvalued dollar, the Bush Administration and Congress have focused lots of attention on China's undervalued yuan, and it does in fact appear to be undervalued. But the problem of trade distorting exchange rates is really much more generic as the central banks of Taiwan, Japan, Korea and others continue to intervene in the currency markets to keep the dollar relatively high and thereby maintain the competitiveness of their exports. If the U.S. improves its savings rate and the Asian currencies are more accurately revalued, it is likely that much of the trade deficit will disappear.

The erosion of the U.S. employment base is a more difficult issue. Job losses are very visible and exceptionally painful. There also can no doubt that the U.S. Government should seek to do something about the job losses. But to develop solutions for the job losses, it is necessary to understand why the jobs are being lost; and it is here that the U.S. political pronouncements are doing more harm than good. By blaming greedy multinational enterprises and unfair trade practices in China, India and other Asian countries for the U.S. job losses, the U.S. is moving toward employment and wealth destroying policies rather than addressing the real causes for the eroding employment base. These policies also may have adverse collateral consequences in other countries and further damage the already tarnished reputation of the U.S. in so many parts of the world.

The real causes for the job losses are economic evolution and productivity improvements within industries. Of course, international trade accelerates both the evolutionary process and productivity improvements so it is easy to conclude that trade is the cause of the job losses. There are, however, two key points to be made:

- The dark and more visible side of economic evolution is the jobs lost through obsolescence. This is what the U.S. politicians are concentrating on at the moment. But the positive aspects of economic evolution are job creation and the generation of new business opportunities, which U.S. politicians are ignoring in part because they often are much less apparent than the job losses. To preserve jobs at risk as a result of economic evolution, however, it is necessary to block or at least retard the creation of new jobs and new businesses. Governments properly should assist in the retraining or relocation of workers hurt through the evolutionary process, but they should not interfere with the evolutionary process itself. Government interference only guarantees slower improvements in economic well-being.

- Productivity improvements have greatly contributed to job losses in the U.S., but as many people outside the U.S. know, erosion of the employment base is not just an American problem. In the last three years, the U.S. economy has lost about 2.7 million manufacturing jobs – and it is claimed that many of those jobs have gone to China. But between 1995 and 2002, the Chinese economy lost *16 million* manufacturing jobs. It is an increasingly global problem, although it is not generally recognized as a problem: increasing productivity is enabling fewer workers to produce more goods and services. According to a recent study of manufacturing jobs in the 20 largest economies, since 1995, approximately 22 million manufacturing jobs were lost throughout the world, even as industrial output increased by 30 percent. As a result, when strong economic growth in the U.S. economy in the third quarter of 2003 failed to produce any notable change in U.S. job creation, the U.S. experience was more the norm than unique.

The issue of job losses does need to be addressed in the U.S. and elsewhere. But once it is recognized that the job losses are inevitable by-products of economic evolution and productivity gains, it is clear that the U.S. Government response should be centered on capturing some of the gains from the evolutionary and productivity improvements to be used for those who have lost their jobs (or lost their businesses). In other words, unemployment insurance and adjustment assistance programs should be used to ease the hardships for those left behind as the U.S. economy advances. The answer is not in China bashing or other gestures aimed at restraining trade, but in using government programs to get workers back into productive employment.

How will it play out?

The spring before a tight presidential race is likely to see the high point in protectionist rhetoric. It is instructive that at this point in the last reelection campaign involving a President Bush, February, 1992, Candidate Bill Clinton was strongly against ratifying NAFTA. In the first year of his presidency, however, Clinton reversed himself and become a strong proponent of NAFTA. In fact, NAFTA's passage occurred only because of Clinton's ardent advocacy.

As the Bush and Kerry campaigns progress over the next seven months, there is reason to hope that more thoughtful ideas will be put forward. Because the U.S. is so sharply divided between the right and left, however, it is likely that special interest groups will continue to have disproportionate influence in setting both administrative policies and the legislative agenda. Because the costs of free trade policies are so much more evident than the benefits, there will be serious political pressures to inject more protectionist measures into U.S. trade laws, especially in the antidumping laws and the rules of origin. The dominant issue in any new bilateral or regional trade agreements also will be the inclusion of U.S style labor and environmental standards.

My expectation is that whether Bush or Kerry wins the next election the basic thrust of U.S. trade policies will continue to support market liberalizations. But I do think there will be a drift towards greater protectionism; I just hope the drift will not be substantial.