

# INTERNATIONAL TRADE, THE ECONOMY, AND US INTERESTS



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## *Our Mission*

The National Committee on American Foreign Policy was founded in 1974 by Professor Hans J. Morgenthau and others. It is a nonprofit activist organization dedicated to the resolution of conflicts that threaten U.S. interests. Toward that end, the National Committee identifies, articulates, and helps advance American foreign policy interests from a nonpartisan perspective within the framework of political realism.

American foreign policy interests include

preserving and strengthening national security;

supporting countries committed to the values and the practice of political, religious, and cultural pluralism;

improving U.S. relations with the developed and developing worlds;

advancing human rights;

encouraging realistic arms-control agreements;

curbing the proliferation of nuclear and other unconventional weapons;

promoting an open and global economy.

Believing that an informed public is vital to a democratic society, the National Committee offers educational programs that address security challenges facing the United States and publishes a variety of publications, including its bimonthly journal, *American Foreign Policy Interests*, that present keen analyses of all aspects of American foreign policy.



## ABSTRACT

*In identifying the major developments that have occurred in the international trading system since the end of World War II, this paper not only explains the complexity of the system but provides two alternative scenarios that may evolve in the context of the crucial presidential and congressional elections of 2008.*

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**W**e are living in times in which the U.S. role in the world economy and especially in the world trading system is being redefined. To get a better sense of what lies ahead of us, we shall look first at some of the most prominent signposts in the evolution of international trade in recent history. We shall afterwards examine some of the most important issues in the current international trade negotiations. Then we will take a selective look at the current political discussions on the economy and offer some considerations on their relevance to the challenges ahead.

### **Before World War II**

A good point of departure is the 1930 tariff law, better known as Smoot-Hawley. By raising customs duties to the highest level in the history of the country, the law contributed to magnifying the effects of the Great Depression.<sup>1</sup> This law became part of an international reality in which tariff wars, quantitative restrictions, and competitive devaluations worsened relations among states across the 1930s, thus in no small measure contributing to the creation of the inter-state political climate of tension that would culminate with the outbreak of World War II.

International tensions notwithstanding, a few years later, the tariff law of 1934 started to move trade policy in the opposite direction. By widening the powers of the Executive, it permitted the president to negotiate reductions of customs duties on a reciprocity basis. Such authority was granted repeatedly by Congress, which is (pursuant to the U.S. Constitution) the holder of the power “to regulate Commerce with foreign Nations”.<sup>2</sup>

### **After WWII**

Toward the end of WWII, the U.S. decided to go from a bilateral to a multilateral negotiating mode. The shift to multilateralism in trade mirrored analogous developments in international monetary affairs with the creation of the International Monetary Fund (IMF), and in the general security arena (and more) with the establishment of the United Nations. The World Bank’s focus, while multilateral, was at first on the reconstruction of war-torn economies. At the World Bank multilateral

development and aid would come to the fore only in the 1950s, as developing countries increased in number and outspokenness.

The first steps to create a new international trading order were very bold and resulted in the Havana Charter, a document that offered rules not just on commercial issues but also in areas like economic development, employment, state trading, preferential systems, and even inter-governmental commodity agreements.<sup>3</sup> It was a document that was too ambitious in terms of the needs it tried to satisfy and the principles it tried to incorporate. The agreement, which was ratified in March 1948 in Havana and which also created the International Trade Organization (ITO), met with substantial opposition in the parliaments of various nations. Most notably, in 1950 President Truman, well aware of Congress's opposition, decided not to push the agreement before the elected body.<sup>4</sup> The agreement was viewed as too reductive of national sovereignty, transferring huge slices of decision-making power abroad.

With the demise of the ITO, the promotion and liberalization of international trade continued through the General Agreement on Tariffs and Trade (GATT). It was a "provisional" agreement, based on principles and procedures of a multilateral nature, and it would be the central pillar of the international trading system for 47 years. It would have at its helm a general director assisted by a secretariat. GATT was the legal child of the economic principles of specialization (so crucial to Adam Smith's vision) and of comparative advantage, the centerpiece of David Ricardo's thinking. Both principles (and later theoretical refinements) basically reflect the two broad empirical realities that countries trade because they are different from one another and that by exporting abroad they try to realize economies of scale.<sup>5</sup>

It is also very important to note the introduction of the principle of non-discrimination through the adoption of the *most-favored-nation clause*, which could be disallowed in the case of existing preferential trading systems, future trade unions (think of the European Community), and free trade associations. One has also to note the "unselfish" leadership of the U.S. which accepted de facto significant discrimination against its own products, among others encouraging the creation of the European Economic Community and Japanese protectionism. It was a Wilsonian vision: a world more open to trade is more inclined toward peace.<sup>6</sup> It was a vision which emanated from American elites and was neither shared nor resisted by the masses, in light of the small importance of the international sector in the U.S. economy at the time.

The first GATT agreements were centered on tariff reductions and soon international trade in the participating countries experienced growth rates higher than those of their GDPs. At the Kennedy Round (1964-67), negotiations were extended to measures against *dumping*, the sale of a product for less than its "fair value" so as to gain market share to the detriment of local producers.

## The Tokyo Round

The Tokyo Round, which lasted from 1973 to 1979, continued to reduce tariffs, which got to be fairly low for industrial products in the richer countries. But by now the problem was another. Governments, pushed by the necessity to find new ways to protect national producers, had started to erect non-tariff barriers (NTBs), e.g. customs procedures, health regulations, national standards, and import quotas. These would turn out to be major obstacles in future negotiations.<sup>7</sup>

It is important to note how the economic challenges of the 1970s (most notably the dollar-gold link coming to an abrupt end in 1971, the high price of oil and other raw materials fueling inflation, the headline-grabbing plant closings, and the growing unemployment) weakened the forces in favor of multilateralism in Europe and the United States. Moreover, American unions had already begun to oppose free trade at the end of the 1960s and by the 1970s the decentralization of power in Congress made protectionist product-specific legislation easier to go through.<sup>8</sup> Further still, the building of the edifice of the European Union (as we call it now) was taking place on the basis of a logic adverse to multilateral free trade, and the *codes* signed by GATT members did not do much to address the issue of the NTBs.<sup>9</sup> The governments of North America and Western Europe thus moved away from multilateralism and started to conclude bilateral agreements and to provide subsidies to their own producers, especially in the farming sector.

## The World Trade Organization

With the Uruguay Round of multilateral negotiations (1986-1994), the number of participating countries reached a record number of 123, and the number and range of topics discussed increased considerably. Agreements on tropical products, improvements in the procedures of dispute settlement, and the creation of a mechanism for comprehensive and regular reviews of national trade policies and practices of GATT members were arrived at with relative speed and ease.<sup>10</sup> The thorny issue of agriculture, which made even more evident the extent to which the European Union (EU) and the United States were the true motors (or, alternatively, blockers) of the process of trade liberalization, was resolved for the time being with the Blair House Accord of 1992. At the final signing ceremony for the Uruguay Round in Marrakesh, the 400-page-long basic document incorporated further cuts in tariffs, greater liberalization in textile and apparel, and agreements on Subsidies and Countervailing Measures as well as on Safeguards. Moreover, the final document included the establishment of new rules on services, intellectual property, and investments to respond to the changed realities of globalization.<sup>11</sup> More specific supplementary attachments brought the number of total pages to 22,000.<sup>12</sup>

With the aim of going beyond the structural limitations that had been reached, a new organization, the World Trade Organization (WTO), was

also created. It replaced (and absorbed) the GATT and broadened its scope. Thus, the agreement signed at Marrakech in 1994 marked a high point in trade multilateralism. It is important to note that the Uruguay Round's success was, in no small measure, attributable to the fact that President Clinton had received on a temporary basis *fast-track authority* from Congress. This enabled the president to submit the final draft of a trade agreement to Congress without permitting the latter to introduce amendments, thereby putting it in a take-it-or-leave-it position. By limiting its own power, thus, the elected body strengthened considerably the president's negotiating hand with foreign governments. Before the final agreement for the Uruguay Round, a new multilateral round of negotiations was already being contemplated, but several years had to go by before its launch. This would happen after the well-known and extensively televised debacle of the meeting of commerce ministers in Seattle in 1999. Going beyond the protests that took place in the streets, any knowledgeable observer knows that the profound differences of opinions among the participants from the various official delegations would not have permitted them to reach a meaningful agreement at that time.

## The Doha Round

In 2001, two months after the attack on the Twin Towers, the ministers of the WTO were capable of reaching an agreement in principle, thus kicking off the Doha Round of multilateral negotiations, which continues to this day. This is a set of negotiations that has experienced significant difficulties. Let us briefly look at the main hurdles that hamper its progress. First of all, the number of participant countries, now about 150, makes negotiations very cumbersome. Then, there is the issue of agriculture about which the Europeans are forced to defend themselves from everyone for the huge agricultural aid given to their farming sector and the Americans are subjected to heavy criticism for their less sizeable but still considerable agricultural support. Some might find it strange that agriculture, the quintessential *old economy* sector, which represents a very low percentage of the US and EU's GDPs, should be considered so important on both sides of the Atlantic. Of course the explanation is found in the activities of powerful lobbies, in concerns over the social impact that the removal of subsidies would have on the people living in the countryside, in fears of reliability of supply, and in concerns stemming from the lack of or poor enforcement of environmental, sanitary, and phytosanitary rules and working conditions in other countries (as with other sectors, it is not easy to separate these concerns from protectionist motivations). In this context, it is also important to note the contribution to anti-free trade positions of the "Group of 33" developing countries (which want to protect small scale farming).<sup>13</sup> In general as a group, developing countries, which represent two thirds of the WTO membership, aim to discuss other issues (for instance industrial sectors, services, intellectual property, investments, settlement of controversies between states) only after the European Union and the United States have made significant concessions on agriculture.

The presence of China, admitted into the WTO in 2001, further complicates the negotiations, given the fears this country engenders on both sides of the Atlantic on account of its prominence in *offshoring* and the job losses associated with it. Offshoring is also linked to the large losses of market share experienced by home-based corporations in a significant number of sectors (with the issue of the protection of intellectual property rights in the Asian giant often linked to such concerns). China is also a country that is developing with little regard to environmental considerations and to labor standards, which is strongly resented in the West both as immoral and a source of unfair competitive advantage. Furthermore, its energy needs (dictated by its double-digit growth) have contributed to the increase in the price of raw materials, an inherent drag on the world economy. And while China's desire for growth is understandable and legitimate, many object to the fact that Beijing, in order to secure such supplies also offers support to some brutal dictatorial regimes (behind the thin veil of the pursuit of a policy of "non-interference"). Thus concerns over human rights, the environment, and labor standards (fueled also by less noble competitive fears) will lead to growing demands that China become a better "global citizen". Recent developments in the areas of food and product safety, and the deployment of UN troops in Sudan provide examples of Beijing's sensitivities to at least some Western concerns. The recent stake that China has gained in the Blackstone group (which has been approved by the U.S. Treasury) has also reminded us of the Unocal and Dubai ports issues and the difficulty of writing investment codes that meet the needs of all parties to multilateral negotiations.

### Other Complications

To complicate matters further, the negotiations have been affected by the fact that President Bush's fast-track authority (actually its equivalent) was set to expire in June 2007. And without it, the risks would increase that the Doha Round of negotiations might fail. As a matter of fact, at the same time the June 30, 2007 deadline was approaching and passing, some additional factors complicating the negotiations became clearer. For instance, at the meeting held in Potsdam in June 2007, the United States and the European Union were less assertive in demanding agricultural concessions of each another, concentrating instead on pushing together for lower industrial tariffs in emerging markets. The ensuing strong resistance by these latter countries has been viewed by many observers as showing not so much these countries' concern of being invaded by products from the United States and the European Union as their fear of being flooded by low-cost products from China.<sup>14</sup> Fear of China underlies also the introduction in June 2007 in the U.S. Senate of a new trade bill requiring the Treasury Department to identify misaligned currencies, and basically permitting U.S. companies to seek relief through the imposition of anti-dumping duties against the goods of the offending country.<sup>15</sup> Such an identification would be based on IMF criteria. The Fund would thus most likely become the object of strong criticism by the countries affected negatively, as some within its ranks rightly fear.

The astute observer understands the impact that this would have on the legitimacy of this and other international financial institutions where, many claim, the Western countries wield a power no longer commensurate with contemporary economic realities. The debate, which sooner or later is bound to take place, will bring to the fore arguments on what the West has done for developing countries and what it should be doing. Negative actions by the West have often been magnified, while positive contributions have gone underappreciated. These debates will also take place against a background where logic would suggest that the Asian countries, which have benefited from free trade, should be pursuing the removal of commercial barriers (and be ready to offer greater concessions across the board), thus trying to compensate for the waning enthusiasm for trade liberalization in the West. But emotions run very deep on these issues and the pursuit of such an agenda by Asian countries may not materialize to a great degree in the near future.

### **Bilateralism and Regionalism**

The Doha Round is also being impacted negatively by the fact that an increasing number of countries are resorting to entering into bilateral or regional trade agreements, which complicate multilateral negotiations and agreements. In a typical free trade agreement (FTA), signatories commit themselves to reducing, within an agreed time span, their customs duties to zero for a significant portion of the trade between them. On the plus side, these agreements increase trade volume between countries and regions and are usually negotiated more speedily than multilateral ones. But the arguments against bilateral trade accords (or at least against excessive reliance on them) are powerful indeed. The Director General of the WTO, Pascal Lamy, in a recent speech has emphasized the main ones.<sup>16</sup> In the first place, such agreements are discriminatory in nature (to the specialist reader a clear violation of the principle of the most-favored-nation), and provide strong incentives to join in so as not to be excluded. This domino or bandwagon effect is very present in the regional trade pacts being agreed to in Asia today. In the second place, adds Lamy, bilateral accords cannot resolve “systemic issues such as rules of origin, anti-dumping, agricultural and fisheries subsidies”.<sup>17</sup> Lamy adds : “There is no such thing as a “bilateral” farmer or fisherman, or a “bilateral” chicken and a “multilateral” farmer or chicken or fish. Subsidies are given to farmers for all their poultry production.”<sup>18</sup> Third, the increase in the number and breadth of regional trade agreements will most likely complicate the environment in which international commerce occurs with rules that are hard when not impossible to reconcile.

Another cluster of complications revolves, once again, around agriculture, specifically the farm bill passed by the House of Representatives at the end of July 2007. Among other things, the bill expands loan and price support programs directed at U.S. producers, gives much greater support to fruit and vegetable farmers (traditionally highly neglected in favor of producers of

commodity crops), provides funds to feed children attending schools in developing countries, and puts more resources into research on biofuels.<sup>19</sup> The bill as it is now written is going to be controversial at home and abroad (and likely to remain so when it becomes law). Consider that, as it has been approved, it includes a provision to tax foreign corporations with U.S. subsidiaries to the tune of about \$7.5 billion over the next ten years, a way to meet the new pay-as-you-go fiscal responsibility criteria that has many internationalists balking. Consider also that the bill essentially does not address the issue of reducing the much criticized high level of subsidies enjoyed by farmers of commodity crops (most notably cotton, corn, soy beans and rice). This is so in spite of a WTO interim ruling on cotton (certain to be appealed and likely to be subsequently upheld), declaring that the continued U.S. support to its farmers is trade-distorting (essentially promoting the ongoing expansion of U.S. production and exports while at the same time depressing world prices), and in spite of the likelihood of additional complaints that could be lodged with the WTO against the United States.<sup>20</sup> A further source of complication for the Doha Round stems from the fact that the EU most likely will confront more WTO challenges as well and continue to be on a collision course with the United States on the issue of genetically modified crops and food.

## **A Major Risk**

There is another major cluster of obstacles to the present and future conduct of international trade negotiations, which also has the potential to damage seriously the international trading system as a whole because it has to do with legitimacy and core issues of national sovereignty. The case of Internet gambling offers a good example of this. In 2003 the small island nation of Antigua and Barbuda became a complainant in a case brought before the WTO against the United States. It argued that the respondent, by preventing its citizens from placing bets online, was in violation of the WTO trade rules on services.<sup>21</sup> When, in April 2007, the WTO ruled in favor of Antigua, the United States, within weeks, unilaterally decided to exclude the cross-border supply of gambling and betting services from the list of services falling under the umbrella of the WTO, taking advantage of an escape clause contained in the WTO treaty.

Several issues underlie this controversy. First and foremost, the United States is concerned about access of minors to internet gambling and the opportunities offered to criminals and terrorists to launder money. Further, the United States argues that when the WTO was created (given also the state of technology and regulation at the time), online gambling was the furthest thing from the minds of the negotiators and, at any rate, few if any would have agreed to it. On account of these factors the United States can feel that it is on the side of the angels and that its jurisdiction should be final on these matters. Understandably, a bipartisan consensus exists on this issue, given the difficulty for any member of Congress to justify a different position on grounds of ethics and national interest.

That said, however, the international impact of such a stance has some ominous aspects. Other countries may feel they can invoke the escape clause in areas of their choosing (e.g. intellectual property protection). Further, many countries may require that, pursuant to the WTO agreements, they be compensated for the loss of present and future earnings. These claims could be truly very large, with the possibility of economic sanctions authorized by the WTO very real. Many of those who support the preeminence of U.S. over international law would use a case such as this as a prime example of the folly of relinquishing significant chunks of national sovereignty to an unelected international body. Many in the United States would thus scoff at the idea of caving in by accepting an “immoral” decision and even worse paying compensation to those who profit from gambling. Time will tell how ongoing arbitration proceedings between the United States and Antigua and bilateral negotiations with other countries will put an end to this controversy. This case shows clearly how easy it is to go from the pursuit of legitimate national goals to confrontation with other countries. It also illustrates how the WTO runs the risk of delegitimization, with countries going from questioning its jurisdiction to ignoring its dispute settlement decisions to, worse still, dismissing as irrelevant its overall framework.

Certainly the edifice GATT+ WTO built from the end of WWII to now has had the great merit of creating rules and procedures that have reduced many of the uncertainties, costs, and risks connected with international trade and investment. But if doubts started to surface often on the validity and legitimacy of such rules and procedures, this edifice could be seriously weakened and even collapse. This would be a disaster. The liberalization of trade has permitted consumers all over the world (not just in the most advanced countries) to expand their choices and obtain products at lower prices than would have been the case in the absence of international trade. Critics of the current international economic order cannot ignore this nor can they brush aside the higher standards of living that we have seen across the world on account of the removal of barriers. In fact, the lowering or elimination of commercial hurdles has certainly played a great role in the very high growth rates seen in so many emerging markets. Furthermore, it can be argued that it was the prolonged insularity of the non-market economic systems of the former Communist economies that played a major role in their collapse (incidentally Russia’s admission into the WTO will add a major player with its own agenda and complicate multilateral negotiations further still). The picture is complicated by the extreme poverty of those countries, almost all of them in Africa, which have not succeeded in benefiting from the present wave of globalization and by the often related issue of the connections between trade and human rights. In this sense one cannot fail to notice that regrettably, when the democratic countries of the West intervene with humanitarian or ethical aims in the internal affairs of countries run by dictatorships (and there are many), they are very often accused of interference for less than noble or even sinister purposes.

## Congress

The 110th Congress elected in November 2006 is more protectionist than its predecessor, part of an ongoing trend of growing polarization of congressional politics. And the 109th Congress was not a great champion of free trade either, as the razor-thin majority of two with which the House of Representatives ratified the Central American Free Trade Agreement (CAFTA) two years ago attests. With progress on trade liberalization within the WTO framework stalling, the default strategy for the Bush administration is the pursuit of regional and, more importantly, bilateral accords, many of which are currently being negotiated. From 2002 to the summer of 2007 the administration has concluded sixteen FTAs, four of which are awaiting approval by Congress.<sup>22</sup> They are those with South Korea (the largest in scope and arguably the most controversial), Peru, Colombia, and Panama. It is important to note that the signing of these and future trade agreements is going to be affected by the May 2007 agreement on labor and environmental standards (to be incorporated in U.S. trade accords henceforth) reached between the White House and Congress. Some have stressed the ambiguous nature of the agreement, especially in light of considerations of international law and the fact that many members of Congress think it does not go far enough. But many would concur that the more free-trade-oriented executive branch has gotten less out of the deal.

## Complexity and the 2008 Elections

Our brief look at the evolution of the international trading system has tried to emphasize its growing complexity. There is an ever expanding number of state actors, whose jurisdictional reach more and more often overlaps with that of others, and at times clashes with them. There is a growing number of multinational companies whose output of products, services, and ideas and whose trading and investing activities increasingly and in countless unforeseen and unforeseeable ways affect us as customers, suppliers, competitors, employees, shareholders or citizens. Nongovernmental actors continue to increase rapidly in numbers, while exerting growing influence on the world trading system with their activities and ideas. Immigration flows of large magnitude, free or forced, continue to change labor markets. Regulators, at the national and sub-national levels as well as in international settings, experience considerable and growing difficulty in keeping pace with these developments and in coordinating their roles.

In spite of its relative decline in terms of percentage of world GDP, the United States remains the most powerful player in the international trading system. Its ability to lead any reform of this extremely complex set of institutions, rules, policies, and practices and to contribute to the removal of current roadblocks is unparalleled. That is the reason why so many from all corners of the world look at us. The campaigns for the upcoming

presidential elections in 2008 and the concomitant renewal of the House of Representatives and one third of the U.S. Senate are engendering debates that will go a long way to redefine our national priorities and interests in international trade for the years to come. Let us look briefly at the main issue areas that will need monitoring in the months ahead.

## **The main issue areas**

### *The War in Iraq*

The war in Iraq - by far the most important issue of the campaigns - together with the war in Afghanistan and the need to prevent nuclear proliferation - will loom very large in the debates ahead but we cannot examine these topics here in any detail. For purposes of their relevance on trade, it seems very likely that greater assistance and support given to the United States in these areas by other countries or the United Nations should move the U.S. public opinion (and leadership) toward less protectionist sentiments.

### *Terrorism on U.S. Soil and Trade*

The United States is one of the most open economies in the world, with goods entering the country by land, air, and sea. For instance, each year more than 11 million containers enter this country by sea. Since September 11, 2001, concern about the possibility that radioactive, chemical, and bacteriological substances could be introduced surreptitiously into the nation for terrorist purposes has mounted. The U.S. government, also acting on congressional mandates, has been trying to address the issue in partnership with other countries through the Container Security Initiative and with the trade community through C-TPAT, the Customs-Trade Partnership Against Terrorism. Among other things, the United States is working on improving the collection of information before cargo lading and toward the creation of an integrated worldwide network of radiation detection and container imaging equipment.<sup>23</sup> These measures all require the very active cooperation of foreign governments and businesses. In spite of their assistance, dictated also by very strong economic motivations, and our agencies' best efforts, there is a grave concern that something dangerous may escape detection and be used for an attack here in the United States. The catastrophic impact of such an act of aggression, in addition to unleashing an extremely forceful response against those responsible or connected even remotely, would certainly precipitate a radical rethinking in this country about globalization and open borders.

### *The Economy and Trade*

International trade is deeply affected by the state of the domestic economy. A period of good U.S. growth permitted it to take the leadership in the process of liberalization of the international economy after WWII. It was a strategy that enabled our allies to strengthen their economies significantly,

reducing considerably the appeal of communism in large portions of their populations and contributing to the strengthening of our security bonds with them. Freer trade provided significant markets for U.S.-made goods and expanded consumer choice in the United States and abroad. The United States gave in terms of market access more than it got but, also in light of the smaller percentage of the external sector in the composition of U.S. GDP, the domestic cost was politically very acceptable. In the seventies and eighties, international trade started to figure ever more prominently in U.S. domestic politics. The materialization of the first trade deficit of the twentieth century in 1971, greater oil dependency, rising unemployment, stagflation, the rise of Japanese economic power, declines in U.S. productivity, and the Third World debt crisis were among the issues that in various ways and degrees at different points in time in the two decades alerted Americans to the fact that the United States was much more dependent than before on events taking place outside its boundaries. Later still, with the end of the Cold War and the entrance into the world economy of billions of individuals capable of underbidding progressively larger numbers of U.S. workers from more and more sectors, the question of the access to the U.S. markets of foreign products (and, increasingly, services) was bound to become even more an integral part of the domestic political discourse and considerably more a source of uneasiness. Uneasiness that, while tempered by good economic growth rates that arguably made the birth of the WTO and NAFTA easier, would also be kept strong by the newspaper headlines decrying the progressively worsening external deficit and debt balances of the United States.<sup>24</sup>

Several factors, all related to one another, will combine with many of those mentioned so far to weigh heavily in the political debates on the economy in the months ahead. We shall sketch out with broad strokes two different economic scenarios and connect each to a different view of the economy, associating each in turn to a different view of international trade and globalization.

## **Two different economic scenarios**

### *The Economy: An Unpleasant Scenario*

The slowdown in the housing market, coupled with decreasing or stagnating values in the capital markets, could cause a significant negative wealth effect. In other words, consumers, feeling poorer, would consume less. Rising unemployment and stagnating real wages would compound the problem. In such a climate of pessimism, private investment would decrease sharply, thus further adding to the downward spiral. In this scenario a recession could be severe and prolonged. Increases in government expenditures or the enactment of major tax cuts or both, aimed at forestalling or reducing the intensity and duration of a recession would probably be resisted by those alarmed by the increases in federal and state deficits. There would be even greater pressure by politicians on the Federal Reserve for accommodative

policies, as the September 2007 rate cut already attests. The Federal Reserve's actions would however be limited by the need to control inflation (think, among other things, of a depreciating dollar and an even more demand-slowing higher price of oil) and not to appear to provide any bailout through rate cuts to reckless market players who could engage again in the future in even riskier behavior. Furthermore, both fiscal policy and monetary policy present, especially now in an integrated world economy, mounting problems in terms of effectiveness (think, for instance, of the differential in growth and inflation rates between developed countries on the one hand and many major emerging markets on the other, which pit against each other their respective monetary policies) and timing. In actuality it is the timing of these measures that makes incumbent politicians' love for them somewhat misplaced. History has taught us that stimulative policies aiming at achieving their desired results by election time do not necessarily succeed.

Even in the absence of very negative economic developments leading inevitably to the placement of a good amount of blame on globalization and free trade, it is very possible that the most unpleasant aspects of adversarial politics may surface anyhow. The debate on the economy may take a strong "winners versus losers" tone and, if that happened, it could reinforce much more the feelings of protectionism among the U.S. electorate. Health care access is a natural issue to trigger such feelings. Granting access to medical care to the tens of millions of uninsured in our country may entail major increases in the costs incurred by U.S. corporations, which could claim not unreasonably that their global competitiveness would be reduced and lead to job losses.<sup>25</sup> The joining of forces of corporations and unions to obtain protection could in this sense be more massive than anything seen in years past. A requirement that foreign producers should offer medical care standards for their workers similar to ours so as to really erase any cost differentials in this area would mitigate anti-globalization feelings in our country. But it would be hard to enforce and arguably create an impossible hurdle for foreign products and services. Tax credits granted to U.S. corporations or, much more, a universal health care system (in the view of many needed and/or inevitable) funded entirely by general federal and state revenues would put a significant burden on current and future U.S. taxpayers. Triggered perhaps by debates on health care reform, U.S. public opinion could also in the months ahead become much more uneasy about the unequal distribution of income and wealth in this country, the very high compensation packages of many CEOs, and the "shrinking of the middle class". Some economists might point out that corporate profits have experienced double-digit growth for years and that those derived from abroad have gone from 20 percent at the beginning of this decade to the current level of 29 percent of the total.<sup>26</sup> As a result, many could be easily be led to make the connection (accurately or inaccurately) between managers' compensation and greater quarterly earnings achieved through the cost reductions obtained via foreign outsourcing, and investments abroad and not at home. Feelings against free trade and foreign outsourcing would grow further still.

Adversarial politics of the type most likely to affect trade is not just engendered domestically. News of defective or dangerous products coming from abroad, made by extremely poorly paid individuals working in unsafe conditions to enrich the few in their countries and the multinationals partnering with them does not help the cause of free trade. Nor do attempts to use third countries to hide the origin of a product. With regard to these practices, China (while not the only offender) comes most readily to mind, especially for the scale at which they take place.<sup>27</sup> International institutions, official national agencies, NGOs, and the media are increasingly documenting levels of air, water, and land pollution that inflict immense human suffering and death in that nation. High levels of use of energy per unit of GDP produced, hasty urbanization, rapid increases in the ownership of highly polluting cars, lack of sewage and water treatment plants, and massive desertification are among the plagues being revealed. More relevant for perceptions among the U.S. electorate (also because not filtered by Chinese authorities) is news of detection of air pollutants directly traceable to China on the American side of the Pacific. News of contaminated agricultural products reaching our shores is bound to prompt here massive support for far greater controls and legislation so as to compel disclosure of country of origin. What we are learning about the very aggressive practices pursued by Chinese MNCs outside of their country in terms of resource acquisition (for instance with regard to logging timber) seems to outdo in terms of damages to natural habitats anything done in the recent past by any Western world multinational. Headline grabbing stories of currency manipulation by Chinese and other emerging markets' authorities to keep the dollar artificially down constitute examples of more grist for the mill for protectionists.

### *The Economy: A More Positive Scenario*

Of course things could go better. The steady growth and inflation experienced in the past two decades could continue. Those who subscribe to this view think there should be a "soft landing" in housing, no major prolonged downturn in the stock and bond markets, and a continued resilience of the U.S. consumer. In this view, a recession would be very moderate and short lived, as were those in the past twenty years. The optimists put greater faith in the capability of the Federal Reserve to effectively control inflation and growth at the same time. Government, corporate, and household debt would be rather manageable. The external debt would continue to be comfortably handled because of foreigners' continued demand of dollar denominated assets, which, in propping up the value of the dollar, would prevent inflation from rearing its ugly head. Underlying this vision of the U.S. economy there is a great emphasis not on various forms of debt divided by GDP but instead divided by net assets, considered by those who hold an optimistic view of the U.S. economy as an impressive collateral against which to borrow.

In this view there is nothing worrisome about high levels of consumption.

Americans spend because they can afford to. Furthermore, foreigners, the argument goes (and it is a good one), are attracted in their investing here by the depth, breadth, resiliency, transparency, and fairly light taxation of our markets.

## The Political Battle Lines

In general, the Democratic presidential and congressional candidates tend to side with the pessimists and will talk about the decline in the standard of living of the poor and above all the (more likely to turn out to vote) middle class, of growing budget and current account deficits and debts, of stagnant wages, of inadequate medical care, of social security and medicare at risk in the years ahead, of the rich benefiting disproportionately from the recent years' tax cuts, putting the blame for them squarely on the current president and his fellow party members in Congress. Republicans will counter by pointing out to a better growth record than that of most nations in the developed world during most of the Bush years, buoyant corporate profits, better compensation for workers than it seems if non-cash benefits such as health insurance are factored in, the benefits of cutting taxes and not leaving the funds in the hands of politicians and bureaucrats (some Republicans will be careful with these claims, since they see them as glossing over the budget deficits and the expansion of government spending of the Bush years, which are so much against what the party has traditionally stood for), and the general opportunities offered by a society where well over half of its richest 400 taxpayers are self-made successes. Republicans will also bring forth the argument that the gap between high and middle income earners materialized in the mid-seventies and that during the Clinton years it was masked by the unsustainable growth rates of a bubble economy, when the seeds for the current large budget and external deficits were also sown.

Democrats can be more readily associated with more protectionist views than Republicans. This facile dichotomy, however, is complicated by forces working at cross purposes. They include: local political (and often populist) pressures; the need of not seeming too inimical to corporate interests (and campaign contributors) thriving on the unfettered capability to move resources worldwide to maximize shareholders' returns; the desire not to appear as promoting class warfare in a most diverse country where competitive labor, capital, and product markets have for decades "lifted all boats"; and the desire not to be locked in positions that once elected would then be untenable given the imperatives and strictures of foreign economic policymaking.

Matters are complicated further by the fact that the economic advisors to politicians are all too aware that the traditional notion that free trade is good in any circumstance is receiving intellectual review by the economics profession, which is increasingly asking itself if some of the models it has used so far explain adequately what is happening today.<sup>28</sup>

## What Lies Ahead

It is difficult to anticipate what will happen in the months ahead and even more after 2009 to our economy and to international trade. It is very likely that the WTO trade negotiations will resume effectively only when a new president enters the Oval Office. It is possible, however, to identify some of the beneficial things that one would want to see taking place.

Our elected officials should try to promote intelligent policies with regard to productivity growth, which is crucial to elevating standards of living in a noninflationary way. While it is most difficult to identify the factors that are at the basis of gains in productivity, we know that maintaining and strengthening our ability to innovate is essential. We can achieve this by, among others: supporting education in science, technology, engineering and mathematics; promoting immigration policies that continue to attract and above all retain some of the top talent from the rest of the world; enacting tax measures fostering investment in research and development; and in general providing an incentive system that rewards the hard-working and capable while removing obstacles for those of them born in less fortunate economic circumstances. This last point is particularly important, since our society needs to continue to offer the highest opportunities for inter- and intragenerational mobility to all segments of its very diverse population. Perhaps even more difficult to do, the current system of designing and implementing retraining programs for workers displaced by offshoring has to be significantly improved and extended, also in the interest of political harmony.

Our leaders should also succeed in inspiring us to modify our consumption patterns so that we derive much more pleasure from the provision to ourselves of public goods such as cleaner air and water, a real challenge that would imply also some substantial reorientation of our formidable marketing industry.

We have to be mindful that at no point in history has the U.S. economy been so dependent on what happens outside our boundaries. While some of the proponents of the optimistic view may not consider the matter as urgent, most adherents to both views on the economy would want to act very soon on the current huge U.S. trade and current account deficits. Caused, among other things, by our cravings for foreign goods and a desire by foreign governments to hold our currency up for mercantilist purposes, such deficits are not sustainable even if they were not growing. Foreigners' accumulation of dollar denominated assets and especially of presently low-yielding U.S. debt may not continue at the current pace because of their needs for currency diversification and quest for better returns. Also, massive current account deficits may become truly unacceptable to Americans if coming at the cost of lower employment levels at lower wages. A process of adjustment for the largest net debtor country in the world has

to be achieved through a combination of three levers: a dollar depreciation (especially against heavily undervalued emerging markets' currencies); less U.S. domestic consumption of imports (a bit painful today, much more in the future if we continue to postpone it), and greater consumption of U.S. goods and services abroad. In other words, with regard to the last two, the United States will have to run current account surpluses, while the countries that at present hold the largest amounts of dollar denominated assets will have to run current account deficits.<sup>29</sup>

To achieve the goal of reducing global imbalances is going to be a very difficult task for the policymakers at the helm of the largest economies of the world. And the needed coordination of macroeconomic policies, exchange rate strategies, and regulatory and supervisory bodies' activities will loom very large in the multilateral trade talks.<sup>30</sup>

To improve this coordination, U.S. policymakers should work much harder at understanding the people who live outside their borders, for instance by utilizing better the knowledge of the many highly educated and skilled Americans who were born and educated abroad and expanding exchange programs. But the processes of adjustment mentioned, as we have seen, are not under our total or even prevalent control. Abroad, even more than here, better leaders would need to emerge to implement them. Leaders who are capable of inducing their populations to save less and consume more imported goods (hopefully in a very environmentally sustainable way), of avoiding manipulating their currencies for temporary and resentment-inducing "neo-mercantilist" gains, and of defending everybody's intellectual property rights in the full awareness that trade should not be a zero-sum game. Above all, leaders, many of whom who have been exposed to our lifestyle through periods of study or work in our country, who must have the courage to avoid seeking foreign scapegoats for largely domestically created problems. Leaders who are willing and able to explain the role of engine for world growth which the United States has performed as "buyer of last resort" for decades and, most importantly, that the United States is too democratic and politically, socially, ethnically and culturally diverse a country to be bent on world economic domination, as many demagogues would have it. If nothing else, our large current account deficits and external debt attest to that.

Linking international trade with security, the environment, health, and human rights will require in the years ahead much imagination and courage. U.S. economic and security interests and those of the entire world cannot and should not be thought of as separate any longer by anyone. An adroit mix of stewardship combining reliance on efficiency-maximizing markets with wise regulations to reduce their excesses and overcome their limitations in the provision of public goods is needed now more than ever. Let us hope that the men and women who govern us on this very small planet will rise to the challenges ahead.



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### Notes

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23. Remarks by U.S. Customs and Border Protection Commissioner W. Ralph Basham on Container Security at the Center for Strategic and International Studies (07/11/2007), available at the CBP.gov Web site. The validation of partner companies, part of the C-TPAT program, is very important also for land transportation. Most notably, Basham states that the “US/Mexico highway carriers [are] our riskiest enrollment sector.” In light also of what one reads in the press about the porous nature of the Canadian border, many opponents of NAFTA claim to feel vindicated.
24. On the United States turning into the largest debtor in the world, see Giuseppe Ammendola, *From Creditor to Debtor. The U.S. Pursuit of Foreign Capital--The Case of the Repeal of the Withholding Tax* (New York and London, 1994).
25. On the numbers of uninsured in the United States, the Census figure of about 47 million is subject to some debate since it includes citizens and noncitizens and people with incomes exceeding the U.S. median income choosing not to insure. Incidentally, obligating the young and healthy to buy insurance may force them into what they may consider an unwelcome shift in the composition of their expenditures.
26. The estimate is Ed Yardeni’s in Stanley Reed, “Overseas, Few Shocks,” *BusinessWeek*, September 24, 2007, 34.
27. See, for instance, Elizabeth C. Economy, “The Great Leap Backward?” *Foreign Affairs*, September/October 2007.
28. See, for instance, Alan Blinder, “Offshoring: The Next Industrial Revolution?” *Foreign Affairs*, March/April 2006 and Stephen D. Cohen, *Multinational Corporations and Foreign Direct Investment* (New York, 2007), especially pp. 222-232.
29. Martin Wolf very clearly outlines how changes in exchange rates (dollar depreciation), greater expenditures relative to potential output in countries running large current account surpluses and the opposite strategies in countries (like the United States) experiencing large current account deficits, shifts in savings rates (with the profligate becoming thrifty and vice versa), and a great increase in the price of tradeable goods and services here in the United States mirrored by the opposite in emerging markets could work toward reducing these huge and unsustainable global imbalances. See Martin Wolf, “Imbalances Will Require Global Solutions,” *Financial Times*, Apr 26, 2005. It is important also to note that reliable numbers on central banks’ holdings of foreign currency are difficult to come by, especially for Asian nations and oil producers as they progressively shift funds into less than transparent stabilization funds and nonreserve official entities. The future investment activities of these “sovereign wealth funds” will be a major presence in the world capital markets in the years ahead, with Morgan Stanley estimating “that 24 of these funds hold assets totaling \$2.3 trillion.” Michael

R. Sesit, Bloomberg News, International Herald Tribune, April 9, 2007, available at <http://www.iht.com/articles/2007/04/08/business/bxatm.php> accessed on October 1, 2007.

30. At this time of writing (end of September 2007) data suggest that the process of adjustment may be already fortunately underway. The U.S. current account deficit has gone down to 5.5% of GDP, from 6.6% a year ago. The growth rates of U.S. exports (admittedly starting from a lower base than imports) are up 15% from last year, whereas imports have gone up only 5%. See “Grim Reality of Market Turmoil Heralds a New Weak Dollar Era,” *The Business*, September 26, 2007. While the biggest problem plaguing the US and world economy seems to be moving toward a gradual resolution, however, it has to be noted that the first steps are probably the easiest. For instance, much of the weight of the adjustment has been borne by the Euro so far, with unpleasant effects on the economies of the Eurozone. The months and years ahead will show how well the world economy manages the interplay of, among other things: the necessary reductions in the Chinese current account surpluses and foreign reserves holdings; the appreciation of the renmimbi (the lack of which in these years has also strongly deterred other Asian countries from letting their currencies appreciate vis-à-vis the dollar); China’s shift toward more socially oriented consumption (such as better health care and better water and air); a decrease of U.S. current account deficits (at least toward a more manageable 3 percent of GDP) aimed at their progressive (near or total) elimination; increases in U.S. savings rates; and risks of sudden massive sales of dollar denominated assets (resulting most likely in a very sharp deterioration or even a collapse of the greenback, a sharp increase in U.S. inflation, and a dramatic fall in equity and housing markets) which could hurt very badly not just the U.S. economy but also plunge the rest of the world into economic disarray. Also to be factored into this complicated process, for instance, are: the possibility of the United States using the WTO to bring a case against China’s currency manipulation on the basis of its being a major export subsidy (one more reason not to let the organization lose its legitimacy), China’s problems with its banking sector, rising oil prices, and the difficulties U.S. consumers have to face in weaning themselves off their excessive buying habits. Moving toward a more balanced world economy would require undoubtedly a continued robust (and once again environmentally sustainable) growth in demand by the BRIC countries (Brazil, Russia, India, and China) and those countries benefiting from the rise in oil revenues. Their transformation into “buyers of last resort” would vindicate all those who have always seen international trade not as a zero-sum game to be “won” by any specific player, but a positive-sum one, where everybody wins.





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