
The Truth About Trade

What Critics Get Wrong About the Global Economy

Douglas A. Irwin

Just because a U.S. presidential candidate bashes free trade on the campaign trail does not mean that he or she cannot embrace it once elected. After all, Barack Obama voted against the Central American Free Trade Agreement as a U.S. senator and disparaged the North American Free Trade Agreement (NAFTA) as a presidential candidate. In office, however, he came to champion the Trans-Pacific Partnership (TPP), a giant trade deal with 11 other Pacific Rim countries.

Yet in the current election cycle, the rhetorical attacks on U.S. trade policy have grown so fiery that it is difficult to imagine similar transformations. The Democratic candidate Bernie Sanders has railed against “disastrous” trade agreements, which he claims have cost jobs and hurt the middle class. The Republican Donald Trump complains that China, Japan, and Mexico are “killing” the United States on trade thanks to the bad deals struck by “stupid” negotiators. Even Hillary Clinton, the expected Democratic nominee, who favored the TPP as secretary of state, has been forced to join the chorus and now says she opposes that agreement.

Blaming other countries for the United States’ economic woes is an age-old tradition in American politics; if truth is the first casualty of war, then support for free trade is often an early casualty of an election campaign. But the bipartisan bombardment has been so intense this time, and has been so unopposed, that it raises real questions about the future of U.S. global economic leadership.

The anti-trade rhetoric paints a grossly distorted picture of trade’s role in the U.S. economy. Trade still benefits the United States

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enormously, and striking back at other countries by imposing new barriers or ripping up existing agreements would be self-destructive. The badmouthing of trade agreements has even jeopardized the ratification of the TPP in Congress. Backing out of that deal would signal a major U.S. retreat from Asia and mark a historic error.

Still, it would be a mistake to dismiss all of the anti-trade talk as ill-informed bombast. Today's electorate harbors legitimate, deep-seated frustrations about the state of the U.S. economy and labor markets in particular, and addressing these complaints will require changing government policies. The solution, however, lies not in turning away from trade promotion but in strengthening worker protections.

By and large, the United States has no major difficulties with respect to trade, nor does it suffer from problems that could be solved by trade barriers. What it does face, however, is a much larger problem, one that lies at the root of anxieties over trade: the economic ladder that allowed previous generations of lower-skilled Americans to reach the middle class is broken.

SCAPEGOATING TRADE

Campaign attacks on trade leave an unfortunate impression on the American public and the world at large. In saying that some countries “win” and other countries “lose” as a result of trade, for example, Trump portrays it as a zero-sum game. That's an understandable perspective for a casino owner and businessman: gambling is the quintessential zero-sum game, and competition is a win-lose proposition for firms (if not for their customers). But it is dead wrong as a way to think about the role of trade in an economy. Trade is actually a two-way street—the exchange of exports for imports—that makes efficient use of a country's resources to increase its material welfare. The United States sells to other countries the goods and services that it produces relatively efficiently (from aircraft to soybeans to legal advice) and buys those goods and services that other countries produce relatively efficiently (from T-shirts to bananas to electronics assembly). In the aggregate, both sides benefit.

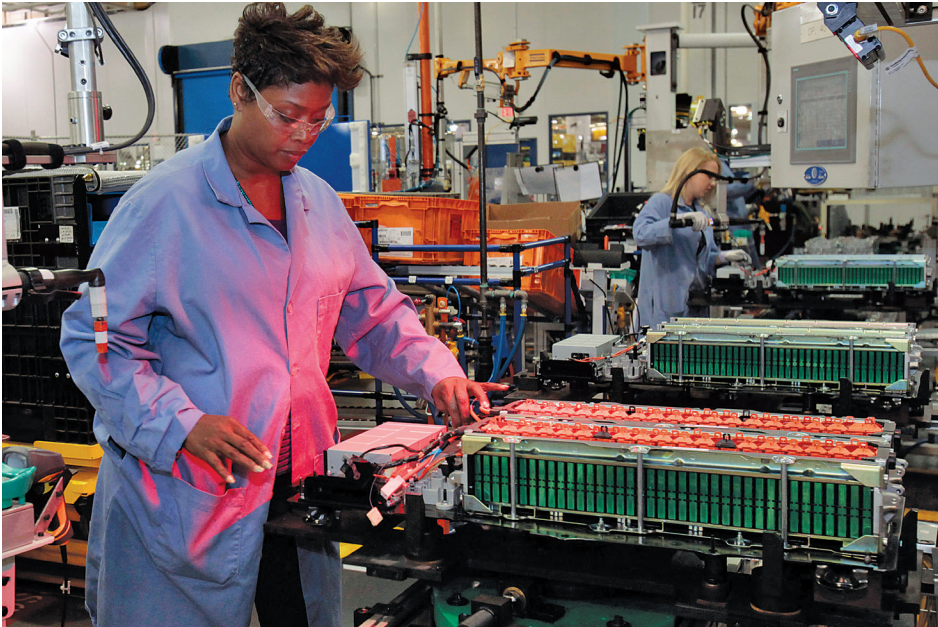
To make their case that trade isn't working for the United States, critics invoke long-discredited indicators, such as the country's negative balance of trade. “Our trade deficit with China is like having a business that continues to lose money every single year,” Trump once said. “Who would do business like that?” In fact, a nation's trade

balance is nothing like a firm's bottom line. Whereas a company cannot lose money indefinitely, a country—particularly one, such as the United States, with a reserve currency—can run a trade deficit indefinitely without compromising its well-being. Australia has run current account deficits even longer than the United States has, and its economy is flourishing.

One way to define a country's trade balance is the difference between its domestic savings and its domestic investment. The United States has run a deficit in its current account—the broadest measure of trade in goods and services—every year except one since 1981. Why? Because as a low-saving, high-consuming country, the United States has long been the recipient of capital inflows from abroad. Reducing the current account deficit would require foreigners to purchase fewer U.S. assets. That, in turn, would require increasing domestic savings or, to put it in less popular terms, reducing consumption. One way to accomplish that would be to change the tax system—for example, by instituting a consumption tax. But discouraging spending and rewarding savings is not easy, and critics of the trade deficit do not fully appreciate the difficulty involved in reversing it. (And if a current account surplus were to appear, critics would no doubt complain, as they did in the 1960s, that the United States was investing too much abroad and not enough at home.)

Critics also point to the trade deficit to suggest that the United States is losing more jobs as a result of imports than it gains due to exports. In fact, the trade deficit usually increases when the economy is growing and creating jobs and decreases when it is contracting and losing jobs. The U.S. current account deficit shrank from 5.8 percent of GDP in 2006 to 2.7 percent in 2009, but that didn't stop the economy from hemorrhaging jobs. And if there is any doubt that a current account surplus is no economic panacea, one need only look at Japan, which has endured three decades of economic stagnation despite running consistent current account surpluses.

And yet these basic fallacies—many of which Adam Smith debunked more than two centuries ago—have found a new life in contemporary American politics. In some ways, it is odd that anti-trade sentiment has blossomed in 2016, of all years. For one thing, although the post-recession recovery has been disappointing, it has hardly been awful: the U.S. economy has experienced seven years of slow but steady growth, and the unemployment rate has fallen to just



Nice work if you can get it: at a Ford plant in Michigan, November 2012

five percent. For another thing, imports have not swamped the country and caused problems for domestic producers and their workers; over the past seven years, the current account deficit has remained roughly unchanged at about two to three percent of GDP, much lower than its level from 2000 to 2007. The pace of globalization, meanwhile, has slowed in recent years. The World Trade Organization (WTO) forecasts that the volume of world trade will grow by just 2.8 percent in 2016, the fifth consecutive year that it has grown by less than three percent, down significantly from previous decades.

What's more, despite what one might infer from the crowds at campaign rallies, Americans actually support foreign trade in general and even trade agreements such as the TPP in particular. After a decade of viewing trade with skepticism, since 2013, Americans have seen it positively. A February 2016 Gallup poll found that 58 percent of Americans consider foreign trade an opportunity for economic growth, and only 34 percent viewed it as a threat.

THE VIEW FROM THE BOTTOM

So why has trade come under such strident attack now? The most important reason is that workers are still suffering from the aftermath of the Great Recession, which left many unemployed and indebted. Between 2007 and 2009, the United States lost nearly nine million

jobs, pushing the unemployment rate up to ten percent. Seven years later, the economy is still recovering from this devastating blow. Many workers have left the labor force, reducing the employment-to-population ratio sharply. Real wages have remained flat. For many Americans, the recession isn't over.

Thus, even as trade commands broad public support, a significant minority of the electorate—about a third, according to various polls—decidedly opposes it. These critics come from both sides of the political divide, but they tend to be lower-income, blue-collar workers, who

*Trade still benefits the
United States enormously.*

are the most vulnerable to economic change. They believe that economic elites and the political establishment have looked out only for themselves over the past few decades. As they see

it, the government bailed out banks during the financial crisis, but no one came to their aid.

For these workers, neither political party has taken their concerns seriously, and both parties have struck trade deals that the workers think have cost jobs. Labor unions that support the Democrats still feel betrayed by President Bill Clinton, who, over their strong objections, secured congressional passage of NAFTA in 1993 and normalized trade relations with China in 2000. Blue-collar Republican voters, for their part, supported the anti-NAFTA presidential campaigns of Pat Buchanan and Ross Perot in 1992. They felt betrayed by President George W. Bush, who pushed Congress to pass many bilateral trade agreements. Today, they back Trump.

Among this demographic, a narrative has taken hold that trade has cost Americans their jobs, squeezed the middle class, and kept wages low. The truth is more complicated. Although imports have put some people out of work, trade is far from the most important factor behind the loss of manufacturing jobs. The main culprit is technology. Automation and other technologies have enabled vast productivity and efficiency improvements, but they have also made many blue-collar jobs obsolete. One representative study, by the Center for Business and Economic Research at Ball State University, found that productivity growth accounted for more than 85 percent of the job loss in manufacturing between 2000 and 2010, a period when employment in that sector fell by 5.6 million. Just 13 percent of the overall job loss resulted from trade, although in two sectors, apparel and furniture, it accounted for 40 percent.

This finding is consistent with research by the economists David Autor, David Dorn, and Gordon Hanson, who have estimated that imports from China displaced as many as 982,000 workers in manufacturing from 2000 to 2007. These layoffs also depressed local labor markets in communities that produced goods facing Chinese competition, such as textiles, apparel, and furniture. The number of jobs lost is large, but it should be put in perspective: while Chinese imports may have cost nearly one million manufacturing jobs over almost a decade, the normal churn of U.S. labor markets results in roughly 1.7 million layoffs every month.

Research into the effect of Chinese imports on U.S. employment has been widely misinterpreted to imply that the United States has gotten a raw deal from trade with China. In fact, such studies do not evaluate the gains from trade, since they make no attempt to quantify the benefits to consumers from lower-priced goods. Rather, they serve as a reminder that a rapid increase in imports can harm communities that produce substitute goods—as happened in the U.S. automotive and steel sectors in the 1980s.

Furthermore, the shock of Chinese goods was a one-time event that occurred under special circumstances. Imports from China increased from 1.0 percent of U.S. GDP in 2000 to 2.6 percent in 2011, but for the past five years, the share has stayed roughly constant. There is no reason to believe it will rise further. China's once-rapid economic growth has slowed. Its working-age population has begun to shrink, and the migration of its rural workers to coastal urban manufacturing areas has largely run its course.

The influx of Chinese imports was also unusual in that much of it occurred from 2001 to 2007, when China's current account surplus soared, reaching ten percent of GDP in 2007. The country's export boom was partly facilitated by China's policy of preventing the appreciation of the yuan, which lowered the price of Chinese goods. Beginning around 2000, the Chinese central bank engaged in a large-scale, persistent, and one-way intervention in the foreign exchange market—buying dollars and selling yuan. As a result, its foreign exchange reserves rose from less than \$300 million in 2000 to \$3.25 trillion in 2011. Critics rightly groused that this effort constituted currency manipulation and violated International Monetary Fund rules. Yet such complaints are now moot: over the past year, China's foreign exchange reserves have fallen rapidly as its central bank has

sought to prop up the value of the yuan. Punishing China for past bad behavior would accomplish nothing.

THE RIGHT—AND WRONG—SOLUTIONS

The real problem is not trade but diminished domestic opportunity and social mobility. Although the United States boasts a highly skilled work force and a solid technological base, it is still the case that only one in three American adults has a college education. In past decades, the two-thirds of Americans with no postsecondary degree often found work in manufacturing, construction, or the armed forces. These parts of the economy stood ready to absorb large numbers of people with limited education, give them productive work, and help them build skills. Over time, however, these opportunities have disappeared. Technology has shrunk manufacturing as a source of large-scale employment: even though U.S. manufacturing output continues to grow, it does so with many fewer workers than in the past. Construction work has not recovered from the bursting of the housing bubble. And the military turns away 80 percent of applicants due to stringent fitness and intelligence requirements. There are no comparable sectors of the economy that can employ large numbers of high-school-educated workers.

This is a deep problem for American society. The unemployment rate for college-educated workers is 2.4 percent, but it is more than 7.4 percent for those without a high school diploma—and even higher when counting discouraged workers who have left the labor force but wish to work. These are the people who have been left behind in the twenty-first-century economy—again, not primarily because of trade but because of structural changes in the economy. Helping these workers and ensuring that the economy delivers benefits to everyone should rank as urgent priorities.

But here is where the focus on trade is a diversion. Since trade is not the underlying problem in terms of job loss, neither is protectionism a solution. While the gains from trade can seem abstract, the costs of trade restrictions are concrete. For example, the United States has some 135,000 workers employed in the apparel industry, but there are more than 45 million Americans who live below the poverty line, stretching every dollar they have. Can one really justify increasing the price of clothing for 45 million low-income Americans (and everyone

else as well) in an effort to save the jobs of just some of the 135,000 low-wage workers in the apparel industry?

Like undoing trade agreements, imposing selective import duties to punish specific countries would also fail. If the United States were to slap 45 percent tariffs on imports from China, as Trump has proposed, U.S. companies would not start producing more apparel and footwear in the United States, nor would they start assembling consumer electronics domestically. Instead, production would

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shift from China to other low-wage developing countries in Asia, such as Vietnam. That's the lesson of past trade sanctions directed against China alone: in 2009, when the Obama administration imposed duties on automobile tires from China in an effort to save American jobs, other suppliers, principally Indonesia and Thailand, filled the void, resulting in little impact on U.S. production or jobs.

And if restrictions were levied against all foreign imports to prevent such trade diversion, those barriers would hit innocent bystanders: Canada, Japan, Mexico, the EU, and many others. Any number of these would use WTO procedures to retaliate against the United States, threatening the livelihoods of the millions of Americans with jobs that depend on exports of manufactured goods. Trade wars produce no winners. There are good reasons why the very mention of the 1930 Smoot-Hawley Tariff Act still conjures up memories of the Great Depression.

If protectionism is an ineffectual and counterproductive response to the economic problems of much of the work force, so, too, are existing programs designed to help workers displaced by trade. The standard package of Trade Adjustment Assistance, a federal program begun in the 1960s, consists of extended unemployment compensation and retraining programs. But because these benefits are limited to workers who lost their jobs due to trade, they miss the millions more who are unemployed on account of technological change. Furthermore, the program is fraught with bad incentives. Extended unemployment compensation pays workers for prolonged periods of joblessness, but their job prospects usually deteriorate the longer they stay out of the labor force, since they have lost experience in the interim.

And although the idea behind retraining is a good one—helping laid-off textile or steel workers become nurses or technicians—the

actual program is a failure. A 2012 external review commissioned by the Department of Labor found that the government retraining programs were a net loss for society, to the tune of about \$54,000 per participant. Half of that fell on the participants themselves, who, on average, earned \$27,000 less over the four years of the study than similar workers who did not find jobs through the program, and half fell on the government, which footed the bill for the program. Sadly, these programs appear to do more harm than good.

A better way to help all low-income workers would be to expand the Earned Income Tax Credit. The EITC supplements the incomes of workers in all low-income households, not just those the Department of Labor designates as having been adversely affected by trade. What's more, the EITC is tied to employment, thereby rewarding work and keeping people in the labor market, where they can gain experience and build skills. A large enough EITC could ensure that every American was able to earn the equivalent of \$15 or more per hour. And it could do so without any of the job loss that a minimum-wage hike can cause. Of all the potential assistance programs, the EITC also enjoys the most bipartisan support, having been endorsed by both the Obama administration and Paul Ryan, the Republican Speaker of the House. A higher EITC would not be a cure-all, but it would provide income security for those seeking to climb the ladder to the middle class.

The main complaint about expanding the EITC concerns the cost. Yet taxpayers are already bearing the burden of supporting workers who leave the labor force, many of whom start receiving disability payments. On disability, people are paid—permanently—to drop out of the labor force and not work. In lieu of this federal program, the cost of which has surged in recent years, it would be better to help people remain in the work force through the EITC, in the hope that they can eventually become taxpayers themselves.

THE FUTURE OF FREE TRADE

Despite all the evidence of the benefits of trade, many of this year's crop of presidential candidates have still invoked it as a bogeyman. Sanders deplores past agreements but has yet to clarify whether he believes that better ones could have been negotiated or no such agreements should be reached at all. His vote against the U.S.-Australian

free-trade agreement in 2004 suggests that he opposes all trade deals, even one with a country that has high labor standards and with which the United States runs a sizable balance of trade surplus. Trump professes to believe in free trade, but he insists that the United States has been outnegotiated by its trade partners, hence his threat to impose 45 percent tariffs on imports from China to get “a better deal”—whatever that means. He has attacked Japan’s barriers against imports of U.S. agricultural goods, even though that is exactly the type of protectionism the TPP has tried to undo. Meanwhile, Clinton’s position against the TPP has hardened as the campaign has gone on.

The response from economists has tended to be either meek defenses of trade or outright silence, with some even criticizing parts of the TPP. It’s time for supporters of free trade to engage in a full-throated championing of the many achievements of U.S. trade agreements. Indeed, because other countries’ trade barriers tend to be higher than those of the United States, trade agreements open foreign markets to U.S. exports more than they open the U.S. market to foreign imports.

That was true of NAFTA, which remains a favored punching bag on the campaign trail. In fact, NAFTA has been a big economic and foreign policy success. Since the agreement entered into force in 1994, bilateral trade between the United States and Mexico has boomed. For all the fear about Mexican imports flooding the U.S. market, it is worth noting that about 40 percent of the value of imports from Mexico consists of content originally made in the United States—for example, auto parts produced in the United States but assembled in Mexico. It is precisely such trade in component parts that makes standard measures of bilateral trade balances so misleading.

NAFTA has also furthered the United States’ long-term political, diplomatic, and economic interest in a flourishing, democratic Mexico, which not only reduces immigration pressures on border states but also increases Mexican demand for U.S. goods and services. Far from exploiting Third World labor, as critics have charged, NAFTA has promoted the growth of a middle class in Mexico that now includes nearly half of all households. And since 2009, more Mexicans have

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left the United States than have come in. In the two decades since NAFTA went into effect, Mexico has been transformed from a clientelistic one-party state with widespread anti-American sentiment into a functional multiparty democracy with a generally pro-American public. Although it has suffered from drug wars in recent years (a spillover effect from problems that are largely made in America), the overall story is one of rising prosperity thanks in part to NAFTA.

Ripping up NAFTA would do immense damage. In its foreign relations, the United States would prove itself to be an unreliable partner. And economically, getting rid of the agreement would disrupt production chains across North America, harming both Mexico and the United States. It would add to border tensions while shifting trade to Asia without bringing back any U.S. manufacturing jobs. The American public seems to understand this: in an October 2015 Gallup poll, only 18 percent of respondents agreed that leaving NAFTA or the Central American Free Trade Agreement would be very effective in helping the economy.

A more moderate option would be for the United States to take a pause and simply stop negotiating any more trade agreements, as Obama did during his first term. The problem with this approach, however, is that the rest of the world would continue to reach trade agreements without the United States, and so U.S. exporters would find themselves at a disadvantage compared with their foreign competitors. Glimpses of that future can already be seen. In 2012, the car manufacturer Audi chose southeastern Mexico over Tennessee for the site of a new plant because it could save thousands of dollars per car exported thanks to Mexico's many more free-trade agreements, including one with the EU. Australia has reached trade deals with China and Japan that give Australian farmers preferential access in those markets, cutting into U.S. beef exports.

If Washington opted out of the TPP, it would forgo an opportunity to shape the rules of international trade in the twenty-first century. The Uruguay Round, the last round of international trade negotiations completed by the General Agreement on Tariffs and Trade, ended in 1994, before the Internet had fully emerged. Now, the United States' high-tech firms and other exporters face foreign regulations that are not transparent and impede market access. Meanwhile, other countries are already moving ahead with their own trade agreements, increasingly taking market share from U.S. exporters in the dynamic

Asia-Pacific region. Staying out of the TPP would not lead to the creation of good jobs in the United States. And despite populist claims to the contrary, the TPP's provisions for settling disputes between investors and governments and dealing with intellectual property rights are reasonable. (In the early 1990s, similar fears about such provisions in the WTO were just as exaggerated and ultimately proved baseless.)

The United States should proceed with passage of the TPP and continue to negotiate other deals with its trading partners. So-called plurilateral trade agreements, that is, deals among relatively small numbers of like-minded countries, offer the only viable way to pick up more gains from reducing trade barriers. The current climate on Capitol Hill means that the era of small bilateral agreements, such as those pursued during the George W. Bush administration, has ended. And the collapse of the Doha Round at the WTO likely marks the end of giant multilateral trade negotiations.

Free trade has always been a hard sell. But the anti-trade rhetoric of the 2016 campaign has made it difficult for even pro-trade members of Congress to support new agreements. Past experience suggests that Washington will lead the charge for reducing trade barriers only when there is a major trade problem to be solved—namely, when U.S. exporters face severe discrimination in foreign markets. Such was the case when the United States helped form the General Agreement on Tariffs and Trade in 1947, when it started the Kennedy Round of trade negotiations in the 1960s, and when it initiated the Uruguay Round in the 1980s. Until the United States feels the pain of getting cut out of major foreign markets, its leadership on global trade may wane. That would represent just one casualty of the current campaign. 🌐