Mercantilist reciprocity or free trade: Globalization at a crossroads

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Introduction

The case for free trade is widely understood among economists but rarely resonates with policymakers or the public. Yet, trade is freer today for most of the world than at any other time in modern history. It was not universal faith in the lessons of Adam Smith and David Ricardo that propelled the world toward freer trade but, rather, acceptance and embrace of a framework best described as “mercantilist reciprocity.” The idea behind mercantilist reciprocity was that governments could use the promise of greater access to their domestic markets as leverage to obtain better market access for their exporters to foreign markets and, in the process, establish rules to liberalize international trade.

During the half century following World War II, many governments participated in a series of multilateral “rounds” of negotiations to reduce tariffs and other trade barriers in hopes of achieving broader economic and geopolitical goals. Freer trade was seen as a tool needed to meet pressing imperatives: rebuilding the war-ravaged global economy, encouraging peaceful relations, suppressing nationalism, ending colonialism, and resisting Soviet expansionism, among others.

Despite the flaws of its premise – that maximizing export access and minimizing import access are the objectives of trade negotiations – mercantilist reciprocity provided the policy space, political cover, and necessary momentum for governments to agree to significant amounts of trade liberalization. Of course, lower trade barriers afford opportunities to exporters. More importantly, they benefit consumers and domestic producers, who can incorporate lower cost inputs into their own production processes.

The World Trade Organization (WTO) was created in 1995 as a product of negotiations during the Uruguay Round, the last of eight successful multilateral negotiating rounds conducted between 1947 and 1994 under the auspices of the General Agreement on Tariffs and Trade (GATT). During that remarkable half century, average tariffs declined from 40% to 4%, world exports increased from US$58 billion to US$9 trillion, and world gross domestic product increased more than sevenfold, from US$3.9 trillion to US$28.1 trillion.2

Institutional sclerosis

The WTO has become sclerotic. Guided by the objectives and ambitions of its member countries, the WTO has been unable to marshal the wherewithal to provide the momentum to broaden, deepen, and modernize the multilateral trading system. Although a few agreements were reached among subsets of WTO members to achieve piecemeal, sectoral liberalization, the WTO era has failed to produce any comprehensive, multilateral trade liberalization. Instead, disagreement and inaction have become the norm. Failure to reach agreements on services trade liberalization, environmental goods provisions, digital trade rules, curbing fishery subsidies, investment facilitation, the definition of “developing country,” and the qualifications that “entitle” members to “special and differential treatment” have culminated in a significant erosion of faith in the WTO’s future.3

In retrospect, it is becoming clear that the commonality of purpose, the economic and security imperatives, and the spirit of internationalism that drove trade liberalization and globalization had begun to ebb even before the WTO was...
Established. Much of the low hanging fruit already had been picked and zero-sum thinking about trade and trade negotiations became more engrained. New liberalization was feasible only at much greater political costs.

A series of developments exacerbated tensions and changed the tenor among members: The emergence of the anti-globalization movement, the first failure of a GATT multilateral negotiating round, the rapid rise of China’s economy after its WTO accession in 2001, and the reactions to those developments by major incumbents, especially the United States. With limited prospects for multilateral trade liberalization, many countries turned to pursuing bilateral, regional, and plurilateral trade agreements.

Now, stagnation

Trade has continued to grow despite a 27-year absence of multilateral trade liberalization. The value of international trade and investment is greater today than it was in 1995, when the WTO was established. It is greater than in 2001, when China joined to WTO and the Doha Round was launched. And it is greater than the value of trade and investment in 2008 – the eve of the Financial Crisis, Great Recession, and collapse of the Doha Round.

However, for reasons discussed in this paper, trade as a share of the global economy has stagnated since 2008. Today, policymakers are more inclined to express doubts about the prudence of interdependence and global supply chains. There is a growing tendency to view trade through a geopolitical lens and to subordinate trade policy to national security considerations. There is evidence of a general failure to reconcile, if not align, domestic and international objectives. There is mounting tension between unilateralist instincts and multilateral trade rules.

Protectionism was once considered an exceptional, temporary, and even shameful indulgence. Today, protectionism is justified on often dubious grounds relating to national security, economic security, cybersecurity, and environmental...
The temptation to cloak garden variety protectionism in seemingly legitimate concerns is what’s proving difficult to restrain.

Unilateralism over multilateralism

The WTO’s capacity to adjudicate on these matters has been attenuated with the suspended operations of the Appellate Body. The world’s two largest economies have made it abundantly clear that they will act unilaterally, regardless of the trade rules, when it suits their interests. Cooperative behavior once considered imperative to promoting internationalism, suppressing nationalism, and fostering global economic growth and common prosperity has given way to a zero-sum mentality. Indeed, governments may be more inclined to view rising nationalism in their countries as a consequence of their having gone too far, too fast in embracing international institutions and as an excuse for retrenchment. In the United States, the Biden administration seems intent on continuing some version of Trump’s “America First” policies.

Certainly, the United States was instrumental to the creation of the GATT and the WTO and indispensable to the global economic progress experienced in the second half of the 20th century. But the combination of US unilateralism in response to increasing concerns about trade, geopolitics, and economic and national security, and China’s doubling down on beggar-thy-neighbor state capitalism is massively distortionary. It is also incompatible with rules-based trade and a threat to the global economic system. There is plenty of blame to go around. However, it would be analytically derelict to ignore the significant and deleterious roles played by the United States and China in fomenting doubt and discord about international trade and its institutions.

The benefits of trade for rich and developing countries alike are well documented. Even if US policy continues being protectionist and unilateralist, and even if China baldly defies multilateral trade rules, it still makes sense for governments to remove their trade barriers or at least not raise them. As this paper argues, exposing one’s economy to foreign competition is a domestic reform intended to improve domestic economic performance. It is not a favor bestowed upon foreign exporters.
The state of global trade

The world seems immersed in a cauldron of brewing crises. The list of problems in need of solutions is long: climate change, pandemics, cyberattacks, human rights abuses, terrorism, economic dislocation, increasing geopolitical frictions, and metastasizing populism, nationalism, and authoritarianism. At a time when problems confronting the global commons require greater and more effective international cooperation, governments are being reminded by their citizens to prioritize their well-being. There are tensions between what are perceived as domestic responsibilities and international imperatives. Some believe that the two objectives are incompatible. This “Us versus Them” dichotomy is most misplaced in the context of international trade, where cooperation and adherence to agreed rules promote peace and prosperity.

Despite these sources of international turbulence, the world remains deeply connected on trade. The volume of global trade seems to have recovered from its pandemic induced decline in 2020 and is on pace to reach a record high in 2021. In 2019, the value of global trade (exports plus imports) amounted to US$50.5 trillion, which constituted 57.6% of global value added or world GDP (see Table 1).

Relative to 2001, the year China joined the WTO, and the Doha Round was launched, world trade in 2019 had more than tripled from US$15.7 trillion. Trade as a share of global value added had grown by 23%, from 46.8% to 57.6%. By this metric, the world became more integrated, and more globalized in the first decades of the 21st century.

However, a closer look reveals that the growth rates of trade and trade as a share of world GDP were greatest between 2001 and 2008 – the high-water mark for this measure of global integration.

<table>
<thead>
<tr>
<th>Year</th>
<th>World GDP</th>
<th>Trade (Exp+Imp)</th>
<th>Trade (% GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>33,447,171</td>
<td>15,666,327</td>
<td>46.8%</td>
</tr>
<tr>
<td>2002</td>
<td>34,724,863</td>
<td>16,414,375</td>
<td>47.3%</td>
</tr>
<tr>
<td>2003</td>
<td>38,947,773</td>
<td>19,121,187</td>
<td>49.1%</td>
</tr>
<tr>
<td>2004</td>
<td>43,883,083</td>
<td>23,226,984</td>
<td>52.9%</td>
</tr>
<tr>
<td>2005</td>
<td>47,535,251</td>
<td>26,609,152</td>
<td>56.0%</td>
</tr>
<tr>
<td>2006</td>
<td>51,521,185</td>
<td>30,498,666</td>
<td>59.2%</td>
</tr>
<tr>
<td>2007</td>
<td>58,058,524</td>
<td>35,427,572</td>
<td>61.0%</td>
</tr>
<tr>
<td>2008</td>
<td>63,708,739</td>
<td>40,698,425</td>
<td>63.9%</td>
</tr>
<tr>
<td>2009</td>
<td>60,436,723</td>
<td>32,494,268</td>
<td>53.8%</td>
</tr>
<tr>
<td>2010</td>
<td>66,162,662</td>
<td>38,588,921</td>
<td>58.3%</td>
</tr>
</tbody>
</table>

Table 1 – Global trade and world GDP (2001-2020), in US$ millions
Figure 1 – Value of world trade (exports + imports), 2001-2020, in US$ trillions

A review of the underlying data in Figure 2 reveals that, between 2001 and 2008, trade-to-GDP ratios increased for 140 of 178 countries (79%). Between 2008 and 2019, trade-to-GDP ratios declined for 106 of those 178 countries (60%). According to this measure, six of every ten countries have become less globally integrated since 2008 by an average “deglobalization” rate of 10%.

Table 2 presents the changing “rates of globalization” for the world’s 25 largest economies. Countries in Group 1 show the same pattern as the world, overall. Global integration increased between 2001 and 2008, and then decreased from 2008 to 2019. Group 2 countries have shown continuous rates of deglobalization.
over two decades. Group 3 countries have shown continuous increases in the rates of globalization. (Note that most of Group 3 are geographically small European countries deeply integrated with the region.)

Spain, the only country in Group 4, exhibits the opposite trend of Group 1 and the world, overall.

Table 2 – World’s largest 25 economies by global integration trend

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2008</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GROUP 1</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>World</td>
<td>46.8%</td>
<td>63.9%</td>
<td>57.6%</td>
</tr>
<tr>
<td>United States</td>
<td>22.7%</td>
<td>30.0%</td>
<td>26.5%</td>
</tr>
<tr>
<td>China</td>
<td>43.5%</td>
<td>62.8%</td>
<td>37.5%</td>
</tr>
<tr>
<td>Japan</td>
<td>21.5%</td>
<td>37.0%</td>
<td>36.3%</td>
</tr>
<tr>
<td>India</td>
<td>27.0%</td>
<td>59.2%</td>
<td>42.0%</td>
</tr>
<tr>
<td>Korea</td>
<td>64.8%</td>
<td>99.8%</td>
<td>77.2%</td>
</tr>
<tr>
<td>Australia</td>
<td>43.0%</td>
<td>46.3%</td>
<td>45.5%</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>67.1%</td>
<td>98.7%</td>
<td>65.3%</td>
</tr>
<tr>
<td>Thailand</td>
<td>128.5%</td>
<td>149.7%</td>
<td>114.0%</td>
</tr>
<tr>
<td>Belgium</td>
<td>156.0%</td>
<td>218.2%</td>
<td>209.9%</td>
</tr>
<tr>
<td>Sweden</td>
<td>76.4%</td>
<td>90.7%</td>
<td>88.4%</td>
</tr>
<tr>
<td><strong>GROUP 2</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>77.1%</td>
<td>67.1%</td>
<td>65.3%</td>
</tr>
<tr>
<td>Russia</td>
<td>61.2%</td>
<td>54.1%</td>
<td>49.6%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>72.5%</td>
<td>61.0%</td>
<td>36.6%</td>
</tr>
<tr>
<td>Nigeria</td>
<td>48.5%</td>
<td>48.3%</td>
<td>36.0%</td>
</tr>
<tr>
<td><strong>GROUP 3</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>66.3%</td>
<td>84.8%</td>
<td>89.1%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>51.0%</td>
<td>58.0%</td>
<td>65.3%</td>
</tr>
<tr>
<td>France</td>
<td>57.7%</td>
<td>60.3%</td>
<td>65.9%</td>
</tr>
<tr>
<td>Italy</td>
<td>51.1%</td>
<td>56.4%</td>
<td>62.7%</td>
</tr>
<tr>
<td>Brazil</td>
<td>25.6%</td>
<td>26.8%</td>
<td>27.4%</td>
</tr>
<tr>
<td>Mexico</td>
<td>47.7%</td>
<td>58.9%</td>
<td>78.6%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>126.3%</td>
<td>165.6%</td>
<td>207.9%</td>
</tr>
<tr>
<td>Turkey</td>
<td>47.4%</td>
<td>50.5%</td>
<td>63.4%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>72.5%</td>
<td>97.9%</td>
<td>115.6%</td>
</tr>
<tr>
<td>Poland</td>
<td>55.0%</td>
<td>83.7%</td>
<td>108.3%</td>
</tr>
<tr>
<td><strong>GROUP 4</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>57.7%</td>
<td>56.5%</td>
<td>68.2%</td>
</tr>
</tbody>
</table>
Similar evidence of deglobalization is apparent in Figure 3, which shows foreign direct investment flows between 2001 and 2019. The figures are revealing. By this measure of global integration, FDI as a share of global GDP was at its peak in 2007. During and after the Financial Crisis and Great Recession, FDI dropped dramatically. In recent years, it has hovered near 20-year lows.

Unmistakable deglobalization

The reasons for the overall deglobalization trend are varied. Some of it may be attributable to increasing demand in places like China, where production once destined for foreign markets is now more likely to be consumed in the domestic market.

Some deglobalization is a function of the repatriation of supply chains for legitimate, economic, risk-based reasons, as well as for political reasons, such as trying to get in the good graces of policymakers who threaten penalties on companies that outsource. Regardless of the motivation, repatriation has suppressed intermediate goods trade, which has contributed to the decline in overall trade as a share of global output.

There is another likely contributor to this trend: Growth in the global economy is increasingly driven by growth in the production and consumption of services, which tend to be traded across borders less frequently than goods. Consumers, businesses, and governments in many countries (including all developed countries) spend more on services than on goods.

Much more so than with goods trade, services trade is subject to numerous, opaque, behind-the-border regulatory barriers. Therefore, production of services increases a country’s GDP (the denominator), the scarcity of imported services means slower growth in the numerator. As a result, the trade data suggest declining rates of globalization.
THE STATE OF GLOBAL TRADE

To offer some perspective, in 2019 US consumers spent US$9.9 trillion on services, of which only US$598 billion (about 6%) were imported. In contrast, US consumers spent US$4.5 trillion on goods in 2019, with imports of goods totaling US$2.5 trillion (56%). That wide disparity in import penetration – 6% for services versus 56% for goods – suggests that the United States maintains fairly significant barriers to trade in services. Ultimately, these are drags on US economic growth. If US import penetration for services were the same as it is for goods (56%), imports of services would have amounted to US$5.2 trillion in 2019, boosting US trade value by US$4.6 trillion.

Accordingly, US trade as a share of GDP would have been 48.0% instead of 26.5% in 2019, which suggests that overcoming barriers in services trade is important to reversing deglobalization. Of course, barriers to trade in services tell only a small part of the story of where we are today in the world of trade.

Subordination of multilateralism and trade policy

With discord at the organization more common than agreement and another upcoming ministerial meeting looking unlikely to deliver tangible outcomes, the WTO risks descending into irrelevance. Its capacity to facilitate momentum toward agreement is in question, its rules are increasingly ignored, and its adjudicative function is out of order. The conditions that enabled multilateralism to flourish in the 20th century have dissipated, while prospects for institutional reforms, trade liberalizing initiatives, or modernizing measures all appear slim. Bloomberg recently reported that WTO Director General Ngozi Okonjo-Iweala, frustrated by the lack of headway only seven months into her four-year term, has floated the idea of resigning if progress on outstanding issues is not made soon.

In stark defiance of WTO rules, US tariffs remain in place on US$360 billion of imports from China – tariffs defended by the United States as more likely than WTO procedures to get Beijing to back away from its non-market, predatory, mercantilist practices. Meanwhile, the so-called “Phase 1” US-China trade deal, which is supposed to lead to eventual removal of the punitive US tariffs, endorses Beijing playing a central role in awarding purchase preferences to US goods and services. China’s industrial policies, the US tariff war, subsequent retaliation, and the terms of the Phase 1 détente are all affronts to nondiscriminatory, market-based trade. They are also major impediments to restoring respect for the rules-based system.

Nevertheless, in a recent speech, US Trade Representative Katherine Tai made clear that the tariffs will remain in place while her office assesses the shortcomings in Beijing’s fulfillment of its Phase 1 obligations. Tai also made clear that US trade policy will focus on shoring up domestic industries and US workers from unfair practices. She did not tamp down rumors that another unilateral investigation into Chinese subsidy practices is coming.

In this increasingly contentious atmosphere, some governments are incentivizing businesses to produce more at home and repatriate supply chains.
Instead of restoring the principle that protectionism in the name of national security should be exceptional, the WTO can only stand by as members subordinate trade policy to geopolitical and national security priorities. The quest for technological prowess and primacy now seems to provide sufficient cover for all forms of unilateral protectionism.

Stephen Olson of the Hinrich Foundation recently summed up this illiberal state of trade as follows:

“In India, Prime Minister Narendra Modi is calling for economic self-reliance and raising trade barriers. China has adopted a dual circulation strategy which puts increased emphasis on domestic demand and relegates trade to a supporting role. The buzzword du jour within the EU is strategic autonomy, which recognizes the need to strengthen domestic production capabilities and reduce over-dependence on trade. And in the US, the Biden administration is pursuing a worker-centric trade policy and has maintained most of the trade restrictions put in place by the Trump administration.”

According to the Global Trade Alert, which maintains a comprehensive database of trade policy interventions taken by governments worldwide since 2009, there has been a sharp rise in “harmful” interventions in recent years. Between 2017 and 2021, the number of protectionist undertakings increased by 220%, steadily rising from 522 in 2017 to 1,678 as of September 2021 (Figure 4).

Meanwhile, the Biden administration assumed office promising to mend fences with allies after four years of protectionist abuse from the Trump administration. In some circles, expectations were high that President Biden would revoke the national security tariffs on steel and aluminum. Eight months into his term, this has yet to happen. Even if he were inclined to lift the tariffs, Biden has little room to maneuver because hotly contested portions of the US electorate support their continuation.

Figure 4 – Harmful interventions in trade policy, 2009-2021

According to the Global Trade Alert, which maintains a comprehensive database of trade policy interventions taken by governments worldwide since 2009, there has been a sharp rise in “harmful” interventions in recent years. Between 2017 and 2021, the number of protectionist undertakings increased by 220%.
For similar reasons, Biden cannot easily scale back the tariffs Trump imposed on China without being perceived as having “caved to Beijing” by organized labor, national security hawks, media, and the relentless Twitterati. Indeed, going tough on China is one of the few US policy “strategies” around which bipartisan consensus has coalesced. Biden has been evasive about his trade policy plans; the only certainty is his pledge to not pursue any new trade agreements until the administration makes sufficient progress on the plight of domestic workers.

Prospects for any US trade liberalization over the next four years were already remote. A bond forged between the Republican party’s economic nationalists and the labor left over the trade restrictive United States-Mexico-Canada Agreement (USMCA) has endured the transition from Trump to Biden. The atmosphere in Washington allows protectionism with broad bipartisan support.24

Defiant state capitalism
China is also willfully violating the WTO rules to advance its technology and industrial policies. Today, China’s model of state capitalism stands in defiance of the very precepts of the rules-based trading system. It routinely generates industrial overcapacity in targeted sectors. It provides state-owned enterprises with favorable access to credit and other advantages, which chases promising companies, industries, and investment out of the sector in other countries. And it causes numerous other economic distortions around the world.25

Beijing has set its sights on technological self-sufficiency and, in some cases, preeminence. Even before the launch of the Made in China 2025 initiative, Beijing was contesting US technological primacy and funneling hundreds of billions of government dollars per year into research, development, and production. It was also underwriting efforts to conduct technology theft on a grand scale, as well as extorting technology and other assets from US businesses as the price of entry into the Chinese market.26

The world’s governments have failed to hold China to its commitments – either through WTO litigation, “strategic and economic” dialogues, investment in new trade architecture, or other channels. This failure has generated political and social blowback in the United States, Europe, and elsewhere. This blowback – and the protectionism it has enabled – must be counted among the costly distortions of Chinese state capitalism.
How did we get here?

The world is more interdependent today than it was in 1947, when representatives of 23 governments formalized their commitments to trade liberalization. Integral to the success strategy of the GATT negotiations was finding the proper “balance of concessions,” so that all parties could claim they won the right amount of export market access for the import market access they had conceded.

The deeper and broader trade barrier reductions achieved using this strategy of “mercantilist reciprocity” contributed significantly to world economic growth during the second half of the 20th century and into the 2000s.

Us versus them

Mercantilist reciprocity, however, contained the seeds of its own destruction. The quandary we face today may signal that this approach has run its course. Most of the low-hanging fruit has been picked: tariff reductions on manufactured goods, limits on agricultural subsidies, harmonization of customs procedures, and other less contentious issues. For policymakers, the political reward for negotiating behind-the-border regulations on cross-border services trade, intellectual property protections, regulatory coherence, or e-commerce rules often does not justify the heavy lift or political backlash from interest groups with vested, non-negotiable interests in the issue.

When trade liberalization was predominantly about relatively transparent border barriers, it was rather straightforward to understand in advance which interests would support and oppose a particular proposal. The path to balancing their costs and benefits within the negotiation was more predictable.

Today, the objective is much more complicated and fraught because many of the issues are socially divisive. Media and social media scrutiny of the processes involved in balancing concessions often result in harsh criticism of the negotiators and accusations that they were outmaneuvered.

Moreover, trade “negotiations” perpetuate and reinforce an “us versus them” outlook that puts exports in the positive column and imports in the negative. If trade negotiators do not perceive exports as good and imports as bad, why do they seek to maximize the former and minimize the latter? Why do they insist that domestic tariffs or professional licensing requirements or onerous and redundant technical regulations are assets? Why have negotiations at all?

Mercantilist reciprocity foments a corrosive way of thinking about trade. Perhaps the negotiating stasis experienced at the WTO and the relative dearth of US free trade agreements is because nobody wants to “give up” more access to their markets than they “win” in the foreign market. Nobody wants to be perceived as having “lost” a trade negotiation. Yet these alleged “assets” are actually domestic rules and regulations that affect most domestic consumers and businesses adversely. Perhaps “trade liberalization” would be more palatable if properly cast as a matter of domestic policy reform.
How Did We Get Here?

The “Battle of Seattle” marked the beginning of several years of intermittent protests of globalization, trade, and alleged environmental and labor exploitation by corporate globalists.

Spent goodwill

Trade negotiations are also flailing because the impetus, goodwill, and momentum that drove creation of the GATT and the WTO have ceased to exist. The economic calculus changed. Even before the Uruguay Round was completed in 1994, concerns in the United States about the economic and employment impacts of trade with Mexico (and other developing countries) had turned organized labor into a perennial opponent of trade agreements.27

At the first WTO Ministerial Conference in Singapore in 1997, the United States and the EU brought the question of labor standards and labor rights to the floor, in a bid to win commitments from members to include such provisions in future agreements. Perceiving the bid as an attempt to deny them their comparative advantages in labor supply, the developing countries stood in opposition.28

The anti-globalization movement took root two years later, when the WTO’s second Ministerial Conference was disrupted by protesters. The “Battle of Seattle” marked the beginning of several years of intermittent protests of globalization, trade, and alleged environmental and labor exploitation by corporate globalists.29

By the time the Doha Round was launched in November 2001, there was little appetite for liberalization – or, at least, for long, drawn-out negotiations over contentious issues. However, the 9/11 attacks injected a new, if temporary, sense of purpose in showing global solidarity.

Two years later at the WTO ministerial meeting in Cancun, negotiations broke down along North-South lines. Developing countries demanded real reforms in US, EU, and other developed-country agricultural practices and real changes in the informal power structure at the WTO.30

In response to the impasse, many countries began to pursue smaller bilateral and regional trade agreements as alternatives to the protracted multilateral approach. As the number of these “preferential” trade deals increased and trade issues became more complex with technological change, the WTO’s centrality to the
trading system began to wane. Although negotiators regrouped and tried to save the Doha Round, ultimately there was too much acrimony over too many matters among too many countries. After a final failed attempt to plow an agreement through in 2008, the Doha Round was unofficially laid to rest.\textsuperscript{31}

Later that year, the United States fell into a financial crisis and recession. Then followed a period of slow recovery, persistently high unemployment, and out-of-control government debt (much of which was owned by the Chinese government). Juxtaposed against the unrelenting growth of China’s economy, which had just surpassed the United States as the world’s largest manufacturer and exporter and was edging toward becoming the world’s largest economy, US policymakers fell into a state of handwringing and introspection, wondering where the United States went wrong and what China got right.\textsuperscript{32}

During the eight years of the Obama administration, US trade policy reflected the conclusion that China’s protectionist practices should be both countered and emulated. There were new tariffs, new trade remedy rules, and new green subsidies. By the time Donald Trump became US president in 2017, the conditions were ripe for the trade war that ensued.\textsuperscript{33}

While the Biden administration talks about the importance of multilateralism and the WTO, it has shown no inclination to deviate from the unilateralist framework favored by the previous administration. Except for subtle differences in tactics, President Biden intends to heed broad bipartisan support for unilateral action and approach China and trade policy in a substantively indistinguishable manner. However, that does not mean governments should discount or abandon pursuit of the reforms needed to grow their economies. Most measures to liberalize trade are distinctly domestic reforms. That those reforms tend to be negotiated between governments – and not between governments and their citizens – engenders suspicion and opposition to trade liberalization. It reinforces the fallacy that trade is a zero-sum game conducted between national monoliths.

A strong positive relationship between openness to trade and economic growth is well-documented in the economic literature. That is, openness to \textit{imports} and economic growth. Study after study has shown that countries that are more open to imports grow faster than those that are relatively closed. David Dollar and Aart Kraay, then at the World Bank, explained that “Openness to international trade accelerates development: this is one of the most widely held beliefs in the economics profession, one of the few things on which Nobel prize winners on both the left and the right agree.”\textsuperscript{34}
The unseen benefits of trade

Trade is an economic endeavor, but trade policy is the product of politics, where perceptions often matter more than facts.

The case for free trade has always been a tough sell. Trade is an economic endeavor, but trade policy is the product of politics, where perceptions often matter more than facts. The economic expansion enabled by free trade is not obvious at first because the adjustment costs from liberalization tend to be concentrated and immediate, while the benefits are dispersed and accrue over time. To synthesize the ideas of Josef Schumpeter and Frederic Bastiat, the “destruction” caused by trade is “seen,” while the “creation” of its benefits is “unseen.”

We see and lament the effects of the textile factory that closes because it cannot compete with lower-priced imports. We can clearly see the rusty gate around the shuttered factory, the idled workers, and the blighted storefronts on Main Street. The media write stories about the wrenching changes of globalization. Those whose jobs are lost or threatened demand action from their political representatives. These things we notice. They are the costs.

What is not typically noticed is the increased spending power of the single mother caring for her children. Not only can she now buy clothing for less, but she has more resources to save or spend on other goods and services. That extra savings or spending underwrites growth elsewhere in the economy.

Consider Apple’s iconic globalization story. By availing itself of low-skilled, low-wage labor in China to produce small components and assemble its products, Apple may have deprived US workers of the opportunity to perform that low-end function in the supply chain. But that decision also enabled iPods, iPhones, and iPads to be priced within the budgets of a large swath of consumers. Had all the components been produced and all the assembly performed in the United States – as President Obama once requested of the late Steve Jobs – the higher costs would have required higher prices, which would have prevented these products from becoming so popular. The incentives for spin-off industries, such as apps, accessories, Uber, Airbnb, and TikTok would have been muted or absent.

Some people object to this process on the grounds that lower prices are not worth the jobs lost or foregone. Indeed, job loss and socioeconomic adjustment are painful. But lower prices are not the ultimate benefits of trade. Lower prices are the transmission mechanism through which economic progress is achieved. The benefits of trade are the resources that become available for investment in promising new firms and industries. Putting resources to better use is how we increase living standards and create wealth.
Why we trade

Imagine life in isolation, waking every morning to attend to the necessities of your survival. You make your own clothes and build and repair your meager shelter. You hunt and harvest your own food, concoct rudimentary salves for wounds and coughs, and engage in other difficult and tedious tasks. Forget leisure or luxuries. All your time would be consumed trying to produce necessities merely to subsist.

Fortunately, most of humanity has improved its organization of economic activity. We no longer attempt to make everything we need or want to consume. Instead, we specialize in a few value-added endeavors – or even just one occupation. Specialization is possible because we accept and embrace the concept of cooperation in the form of exchange.

By specializing, we can focus our efforts on what we do best and produce more value than would be possible if we, as individuals, tried to produce all our needs and wants, because we can exchange our output (monetized in the forms of wages and salaries) for the output of others. Consequently, we don’t have to know how to hammer a nail, mix mortar, sew clothes, hunt deer, or other details of the complex processes and supply chains that generate the products and services we consume.

If two people focus on the tasks in which they excel and exchange their surpluses to enable more and higher quality consumption, scale can follow. Four people – or eight or eighty or eight million – participating in this cooperative economic relationship can lead to much higher volumes of output and greater consumption and savings.

Exchange enables us to specialize. More participants making exchanges within a market enable greater scope for more refined specialization. That means greater
opportunities to match individuals’ precise skills and faculties with increasingly specialized tasks and professions, which emerge in response to the increasingly refined demands of societies.

This bears repeating. Trade enables us to specialize. Specialization enables us to produce more. Producing more enables us to consume more. More and better consumption is the purpose of trade.

The benefits of trade come from imports, which deliver more competition, greater variety, lower prices, better quality, and innovation. The real benefits of trade are measured by the value of imports that can be purchased with a unit of exports – the so-called terms of trade. When we transact at the local supermarket, we seek to maximize this value by getting the most for our dollars.

But when it comes to trading across borders or when our individual transactions are aggregated at the national level, we seem to forget these basic principles. We assume that the goal of exchange is to achieve a trade surplus. We forget that trade barriers at home raise the costs of imports and reduce the value of imports that can be purchased with a unit of exports. We become prone to the fallacy that trade is a zero-sum game, and its purpose is to maximize national exports and minimize national imports.

Not a zero-sum game

Politicians often portray trade as a competition between “Us” and “Them.” Exports are our points, imports are their points, and the trade balance is the scoreboard. In the United States, that scoreboard usually shows a deficit. On the political stump, this is characterized as the United States losing at trade and losing because the foreign team cheats.

This fundamental mercantilist fallacy about the purpose of trade has a nationalistic appeal. In this configuration, the home country is a monolithic entity best served by policies that strengthen its stature vis-à-vis a foreign monolith. But trade does not occur between countries. Trade is the culmination of billions of daily transactions pursued by individuals seeking to obtain value through exchange. Moreover, the proliferation of cross-border investment and transnational supply chains over the past few decades demonstrates that trade is more of a collaboration than ever before. Intermediate goods trade accounts for close to half the value of all global goods trade.

How can imports be viewed as the other team’s points under those circumstances? Who, in fact, are “we” and who are “they”? The claim that a trade deficit signifies loss – “losing, for many years, 600 to 800 billion dollars a year on trade,” as Trump characterized it – is another commonly invoked trade myth.

This view reflects a fundamental misunderstanding of international economics. Trade deficit scolds claim that, when Americans purchase more goods and services from foreigners than foreigners purchase from Americans, US factories, farmers, and service providers are deprived of sales, which reduces domestic output and employment. This conclusion relies on the assumption that the dollars sent to foreigners to purchase imports do not make their way back into the US economy. But the dollars that go abroad to purchase foreign goods and services (imports) and foreign assets (outward investment) are matched nearly identically by the dollars that come back to the United States to purchase US goods and services (exports) and US assets (inward investment). Any trade deficit (net outflow of
In years when imports increase, GDP also increases. In years when imports decrease, GDP also decreases. In all but five years between 1975 to 2019, imports and employment increased (or decreased) in tandem.

That annual capital surplus underpins investment, translates into purchases of domestic goods and services, and fuels economic growth.

Figures 5 and 6, below, demonstrate very clearly that imports are not “the other team's points” and that the US trade deficit does not mean the United States is losing at trade. Figure 5 shows that the value of US imports and US GDP move in tandem. In years when imports increase, GDP also increases. In years when imports decrease, GDP also decreases. Only once between 1975 and 2019 – that’s 45 years – did this relationship fail to hold; witness the one observation in the upper left quadrant. This is not to say that imports cause GDP to rise, but that when the economy is growing, consumers (and businesses and governments) purchase more imports – and more domestic goods and services too.

Likewise, Figure 6 demonstrates that imports are not the threat to domestic employment that trade skeptics claim. In all but five of those 45 years, imports and employment increased (or decreased) in tandem. If imports were an important cause of job loss, we would see many more observations in the upper left and lower right quadrants. Again, this is not to say that imports cause job growth, but that imports increase as the economy expands and an expanding economy creates new jobs.

Figure 5 – Annual changes in real imports and real GDP, 1975-2019

Note: Each dot in Figure 5 represents a given year's percentage change from the previous year in both the value of imports and GDP.
Outsourcing is a complement to (not a substitute for) domestic production

Even before the pandemic and worsening geopolitical rivalry triggered policymakers’ demands for reshoring and repatriation of supply chains, globalization and outsourcing were already in the crosshairs of trade’s detractors. Yet globalization was not preordained. Globalization is a natural consequence of the world adjusting to seismic technological, political, economic, and demographic changes.

Recent decades have seen numerous opportunities emerge for international cooperation and collaboration. First there were innovations that led to dramatic declines in the costs of communication and transportation. Then there was political and economic liberalization, such as the fall of the Soviet Union; China’s opening to the world; and the unilateral and multilateral easing of restrictions on trade and capital flows. There were improvements in educational attainment; the proliferation of manufacturing skills; and, a wave of democratization across many regions.

Globalization took place as the world’s producers responded to the growing demand of consumers seeking more choices, better quality, and lower prices.
Producers, too, sought better options and explored more cost-effective ways to compete in meeting that growing demand.

The global supply chains that emerged were the result of a confluence of factors shaping millions of investments and production-location decisions. Detractors assert that this “outsourcing” of production follows the pattern of a “race to the bottom,” with investment flowing to locations where wages are low, and labor, environmental, product-safety, and other regulations are weak or nonexistent. But reality does not typically hew to this cliché.

Investment and production-location decisions are based on many factors that affect the total cost of producing goods and getting them to market on schedule. Among those factors are, indeed, wages and the regulatory environment. But the factors are multi-fold and include, among others:

- skills of the workforce
- access to transportation infrastructure
- quality of communications infrastructure
- tariffs
- customs clearance procedures
- other trade barriers
- proximity to domestic and foreign markets
- stability of the economic and political climates
- risk of asset expropriation
- respect for the rule of law
- public health.

What matters to investment location decisions are the total costs, from a product’s inception to its consumption. Repatriating or moving supply chains to other countries in response to changing costs and risk profiles is to be expected. Presumably, businesses try to do what
WHY WE TRADE

is in their best interests. It does not make sense, however, to force repatriation of supply chains that are located where they are as a result of careful analysis of risk and other investment location factors. Such coercion will only raise costs for businesses, reduce efficiency, and deprive countries – particularly emerging markets – of much needed investment. They also impede success at home.

Figures 7, 8, and 9 are evidence of the complementary nature of outsourcing and domestic production. Each chart plots the percentage change in the activity of US parent companies and their majority-owned foreign affiliates. If outsourcing is a substitute for domestic production, we would expect to see most of the observations in the upper-left and lower-right quadrants. But for each figure – depicting changes in value added (Fig. 7), capital expenditures (Fig. 8), and compensation (Fig. 9) – most of the observations are in the upper right and lower left quadrants, indicating that when the foreign operations of US companies expand abroad, they also expand at home, in the United States. When they contract abroad, they contract at home, too.42

**Figure 7 – Capital expenditures (annual % changes)**

![Figure 7 - Capital expenditures (annual % changes)](image-url)
WHY WE TRADE

Figure 8 – Value added (annual % changes)

Unilateral trade liberalization

Trade barriers are regressive taxes. They burden lower-income families more than upper-income households because the absolute cost increase of a product or service caused by the tariff represents a higher percentage of a lower-income family’s earnings. For the same reason, trade and measures that liberalize trade disproportionately benefit lower-income consumers and small businesses.

The burdens of tariffs, regulations, and other protectionist measures are greater on small businesses than on large ones. The cost of absorbing tariffs and having internal procedures and personnel to deal with such administrative burdens constitutes a larger share of a small company’s total operating costs. What may be a minor speed bump for large companies can be a significant imposition on small firms.

Today it is more difficult to win popular support for trade liberalization. Too many people consider the reduction of domestic trade barriers to be concessions to foreign competition rather than reforms that benefit domestic consumers and businesses. This is especially true now that services liberalization and behind the

The cost of absorbing tariffs and having internal procedures and personnel to deal with such administrative burdens constitutes a larger share of a small company’s total operating costs.
When trade barriers and regulatory rules that raise costs for domestic businesses and consumers are portrayed as domestic problems with domestic solutions, the dynamics change. Removing the foreign component from the equation could quell domestic resistance to what would otherwise be perceived as welcome domestic reform. When trade barriers and regulatory rules that raise costs for domestic businesses and consumers are portrayed as domestic problems with domestic solutions, the dynamics change. They could change enough to enable trade liberalizing reforms.
Conclusion

Mercantilist reciprocity has reinforced a flawed way of thinking about trade that helps explain the rise of protectionism and the ease with which some governments flout their commitments to the trade rules in favor of unilateralism.

The global trading system was built on the shaky foundation of mercantilist reciprocity. Although the approach succeeded at producing eight rounds of multilateral trade liberalization over 50 years and scores of bilateral and regional agreements, it has fomented fallacies and misconceptions about the benefits and costs of trade. Those misconceptions have made the process of trade liberalization more difficult and the prospect of future successes through this approach quite remote. Mercantilist reciprocity has reinforced a flawed way of thinking about trade that helps explain the rise of protectionism and the ease with which some governments flout their commitments to the trade rules in favor of unilateralism.

The conditions that generated the momentum that enabled the reduction and removal of trade barriers have changed. Domestic politics, national security concerns, and geopolitics conspire against the economics and the prospects for resuscitating multilateralism.

Our collective challenge is to remind ourselves – indeed, to internalize – that trade barriers are not assets to deploy at the negotiating table, but impediments to domestic businesses, workers, and consumers. Trade barriers raise the cost of production for domestic producers and the cost of living for citizens. They deter the inflow of direct investment, which retards capital spending, employment, and economic growth.

It bears repeating. We trade so that we can specialize. We specialize so that we can produce more. We produce more so that we can consume and save more. More and better consumption – higher living standards and wealth accumulation – is the purpose of trade. Mercantilist reciprocity and the false idol of trade surpluses are harmful distractions.
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Daniel Ikenson is an economist and renowned international trade expert who has spent over 30 years analyzing, communicating, and influencing the formulation of US and global trade policy. In 2021, Dan joined ndp | analytics after nine years as director of the Cato Institute’s Center for Trade Policy Studies, where he led a team of lawyers, economists, and political scientists conducting research on all manner of trade policy.

On subjects spanning from free trade agreements to international investment treaties, trade laws to customs procedures, digital trade to the manufacturing economy, Dan has written dozens of policy papers, given congressional testimony, submitted statements and comments on proposed regulations to federal and state agencies, appeared on national news programs, and published scores of op-eds and articles in prominent media outlets.

Prior to joining the Cato Institute in 2000, Dan was director of international trade planning for an international accounting and business advisory firm. In 1997 he cofounded an international trade consulting firm in Washington, and from 1990 to 1997, Dan was a trade policy analyst at international trade law practices. In addition to his many studies and articles, Dan is coauthor of the book Antidumping Exposed: The Devilish Details of Unfair Trade Law. He earned an MA in economics from George Washington University.

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With the risks and uncertainties associated with public health crises, climate change, rising protectionism, US-China tensions, and other geopolitical concerns growing, the international trade and cross-border investment policy landscapes are changing rapidly. ndp | analytics is committed to broadening, deepening, and strengthening its presence in the international trade space to better assist businesses, governments, and NGOs make sense of – and capitalize on – the shifting policy winds.

2. The tariff and export figures are for the period 1947-2005 and come from “Trade policy agenda and 2005 annual report of the President of the United States on the trade agreements program” (Washington: Office of the United States Trade Representative, March 2006), p. 3; the GDP figures are for the period 1948-2000 and come from “Doha WTO Ministerial 2001: Briefing notes: some facts and figures,” World Trade Organization. Figures are in constant 1990 dollars. Per capita gross domestic product growth tripled from $1,591 to $4,642.


4. The WTO Appellate Body has ceased to function because it lost its quorum. The AB is supposed to have a stable of seven judges, with a minimum of three to decide any appeals. On December 11, 2019, the terms of two judges expired, leaving one remaining judge. Replacements have not been named because the United States, objecting to certain aspects of the AB’s operation, has refused to support any candidates.

5. Note the massive, market-distorting subsidies Beijing bestows upon Chinese firms in pursuit of its Made in China 2025 goals and the unilateral US tariffs imposed on $360 billion of imports from China in response. Both sets of actions baldly defy the spirit and rules of the WTO.

6. There is a growing number of examples of trade protectionism and domestic preferences supported or sponsored by the Biden administration, including tightening of Buy American restrictions on ballooning government spending; $52 billion of subsidies to US semiconductor producers; continuation of tariffs on imported steel and aluminum; and continuation of the trade war with China.

7. Data from 2020 are aberrational on account of the pandemic and 2021 data are incomplete. The subsequent analysis considers data through 2019.


9. Data from the World Trade Organization; trade data include goods and services.

10. Data from the World Trade Organization and the World Bank; trade data include goods and services.

11. The rate of deglobalization was calculated as the percentage change in global trade-to-GDP ratios between 2008 to 2019.


18. Concerns about reliance on foreign suppliers of PPE, medical equipment, pharmaceuticals, rare earth minerals, semiconductors, critical manufacturing components, basic foodstuffs, and many other products with limited claims to national security importance have produced laws, regulations, and more subtle incentives to compel businesses to make more in their home countries.


20. Beijing’s Made in China 2025 program is an unabashed commitment of government resources to the pursuit of technological self-sufficiency or preeminence. The “Creating Helpful Incentives to Produce Semiconductors for America” Act (CHIPS for America Act) would funnel over $50 billion to US semiconductor manufacturing and research. Similar measures have been unveiled recently in Europe and Japan.


22. Harmful measures include actions such as subsidies, contingent trade-protective measures, export-related measures (incl. export subsidies), tariffs, investment measures, etc. See https://www.globaltradealert.org/global_dynamics/day-to_0925/flow_all.


35. In his book Capitalism, socialism and democracy, German economist Joseph Schumpeter developed the concept of “creative destruction,” which explains that progress necessarily
requires destruction of prior economic structures. In his essay “That which is seen and that which is not seen,” French business writer Fredric Bastiat brought to light our tendencies to focus only on the immediate effects of policy, while ignoring the secondary effects.


39. Source: US Bureau of Economic Analysis


41. As of 2019, the stock of FDI in the US manufacturing sector amounted to $1.8 trillion or 40 percent of the total stock of FDI in the United States. China’s manufacturing sector attracted the second largest amount of FDI, with a stock of $443 billion or 26 percent of the total stock of FDI in China; OECD, UNCTAD, and Santander Trade, https://santandertrade.com/en/portal/establish-overseas/china/foreign-investment.

42. Data for Figures 7-9 are from the US Bureau of Economic Analysis, Activities of Multinational Enterprises.

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