21st century economy deserves better than 16th century trade policies

By: Daniel Ikenson - October 12, 2012

It has been 18 years since the last round of successful multilateral trade negotiations concluded. The so-called Uruguay Round, which produced a number of comprehensive agreements to reduce trade barriers and established the World Trade Organisation as an arbiter of trade disputes, remains the high water mark in the annals of multilateral trade accomplishments.

Despite nearly two decades of trying to build on that success – most prominently through the ill-fated Doha Round negotiations – international consensus for new agreements has been elusive. Lack of political will, too many governments with disparate objectives, and mission creep raising national sovereignty concerns have all been cited as reasons for Doha's demise. Yet, this lack of progress has not impeded trade perceptibly. Indeed, world trade as a share of global GDP increased year-over-year, in every year over the past decade except 2009.

Give some credit to lagged implementation of Uruguay Round commitments, as well as to an increase in bilateral and regional agreements. But trade negotiations may be less important than once thought.

More of the credit for increased trade flows belongs to unilateral liberalisation of import barriers, the emergence of once sluggish and moribund economies in the developing world, and the ongoing revolutions in communications and transportation, which have inspired disaggregation of production processes and enabled the emergence of a truly global division of labour.

In a global economy increasingly characterised by cross border investment, international collaboration in production and integrated, transnational supply chains, the mercantilist "Us-versus-Them" zero-sum game assumptions at the heart of most governments' trade negotiating strategies have become outdated to the point of being counterproductive.

It is difficult to imagine how negotiations based on the fallacy that import liberalisation

is a grudging concession made to secure better access to export markets can persist very much longer, when a growing number of domestic interests in every country require greater access to imports.

One common explanation for why governments did not descend into a spiral of tit-for-tat protectionism during the Great Recession, as they did at the outset of the Great Depression, is that multilateral trade rules, which did not exist in the 1930s, prevented a trade war in 2009.

That may carry some weight, but a more plausible explanation is that in 2009 virtually all major trading nations had producers, who rely on access to imported intermediate goods to produce their final products, insisting on openness. In the 1930's very few such entities existed, as nearly all of the components of a final product were usually made in the same country.

In 2009, when G20 trade and finance ministers were pledging and reassuring each other that they would not turn to protectionism, the Canadian and Mexican governments decided to reduce tariffs on most industrial inputs. Why? Because they recognised that business revenues would suffer on account of contracting global demand, and that dropping tariffs would reduce costs of production and preserving some profit margin.

Imports have always produced the enduring benefits of expanded trade – greater choice, better quality, lower prices and domestic efficiencies inspired by stronger competition. But the trend toward transnational production puts a growing number of producers – not just consumers – on the pro-import side of the ledger. And that makes current trade policy formulation particularly anachronistic and untenable.

But for the time being, the common fallacies about imports are reinforced by politicians and media, who depend on sports metaphors to confer meaning and to inspire actions, always with the effect of obscuring the real benefits of trade. Hence, in the United States exports are considered Team USA's points, imports are the foreign team's points, the trade account is the scoreboard and the several hundred billion dollar trade deficit means that Americans are losing at trade. And they're losing – so the story goes – because their trade partners cheat.

President Obama has done little to correct those misperceptions. In fact, he's fanned the flames, as has Mitt Romney, who promises to crack down on China's rampant unfairness, which he blames for US job loss, on his first day in office. The president exhorts US exporters to "win the future" or to secure foreign market share before other countries' exporters get there, as if the size of the pie were fixed.

This encouragement, with its incessant emphasis on exports as the benefits of trade and imports as costs we must minimise, only reinforces the misconception that trade is a zero-sum game with distinct winners and losers. But trade is a voluntary transaction that occurs, not between countries but, between individuals or businesses seeking to maximise value. The transaction would not occur if both parties didn't perceive themselves as being made better off. Yet policy and rhetoric enshrine the myth that the party on the import side is somehow made worse off.

The centrepiece of the Obama administration's trade policy is the National Export Initiative, with its goal of doubling US exports over five years to reach $3.14 trillion by the end of 2014. The NEI identifies all sorts of levers the US government will pull to assist exporters – systematically rigid enforcement of trade agreements, conclusion of new agreements, tax-payer-backed export financing, government-chaperoned and subsidised marketing trips abroad and more.

But the NEI systemically neglects a broad swath of opportunities to facilitate exports by contemplating only the export-oriented activities of exporters. Nowhere in the NEI's 68-page plan to double exports is the word "import" mentioned, except with respect to the section that speaks about strengthening the trade remedies laws to better discipline "unfair" imports.

The NEI presumes that US exporters are born as exporters. But before those companies are exporters, they are producers. As producers first, most exporters are consumers of capital equipment, raw materials and other industrial inputs and components.

Many of the inputs consumed by US producers in their operations are imported or the costs of the inputs are affected by the availability and prices of imports. Indeed, "intermediate goods" and "capital equipment" – items purchased by producers, not consumers – accounted for 58 per cent of the value of all US imports last year. That would suggest that imports are crucial determinants of the profitability of US exporters, and not the scourge described in popular rhetoric.

Yet the NEI commits not a single word to the task of eliminating or reducing the burdens of government policies that inflate import prices and production costs – as the Canadians and Mexicans did for their businesses in 2009. By neglecting these domestic impediments, the administration pretends that the obstacles to US competitiveness and export success are all foreign-born.

The reform focus must be broadened to include consideration of the full range of home grown policies – such as taxes, regulations, tariffs and contingent protectionism – that affect US producers and put them at a disadvantage vis-à-vis foreign competitors. And

that portends a very different kind of trade policy.

In the 21st century, it is inaccurate to characterise international trade as a competition between “us” and “them”. Because of foreign direct investment, joint ventures and other equity-sharing arrangements, quite often “we” are “they” and “they” are “we”.

The largest steel producer in the United States is Mittal, a majority Indian-owned company with headquarters in Europe. The largest German steel company, Thyssen-Krupp, recently completed a nearly $4 billion investment in Mobile, Alabama to serve, among other markets, the growing number of foreign-nameplate automakers producing throughout the southern United States. Nearly 6 million Americans work for foreign-owned companies in the United States.

“American” icon General Motors now produces more vehicles in China than it does in the United States. And the multinational production and supply chain through which Apple products famously make their way from drawing boards, laboratories and design centres in the United States to components factories throughout Asia to assembly plants in China and then into the hands of the world’s consumers exposes the banality of national trade accounting, which presumes to confer a “Made in” status on products to facilitate the imposition of import barriers. How absurd.

Current US trade policy, with its tendency toward bestowing favours on chosen exporters and serving as a conduit of corporate welfare and industrial policy, stands in stark contrast to the naturally and rapidly evolving global commercial environment, with its rich soil ready to fertilise competing combinations of labour, physical capital and human talent – tomorrow’s providers of abundance.

Policies that do not try to channel incentives for the benefit of specific groups or specific objectives but instead provide the greatest opportunities for citizens to partake of the opportunities afforded by our increasingly integrated global economy are the ones that will maximize economic growth and national welfare.

Producers operating in the United States, whether they are domestic, foreign or some combination of the two, compete with other producers for US and foreign market share. So do their upstream suppliers and downstream customers. In this competition, policy should be neutral.

Rather than predetermine winners and losers, trade policy should aim to attract human capital and financial investment to the highest value-added activities possible. Of course that implies a considerably diminished role for trade policy, which should be focused exclusively on ensuring openness and predictability with respect to import rules and

customs procedures. The rest depends on transparent financial regulations, liberal immigration policies, limited frictions in labour, financial and goods markets, and respect for and adherence to the rule of law.

Although trade's critics speak of a "race to the bottom", where governments compete for investment by lowering the standards – a concern unsupported by trade and investment flows – it is really more appropriate to speak of a race to the top.

Governments are competing for investment and talent, which both tend to flow to jurisdictions where the rule of law is clear and abided, where there is greater certainty to the business and political climate, where the spectre of asset expropriation is negligible, where physical and administrative infrastructure is in good shape, where the local work force is productive, where there are limited physical, political, and administrative frictions and so on. Thus, there is a race to the top, as governments compete to secure for their people the highest value-added rungs possible on the global supply chain.

This 21st century economic reality demands better than trade policies rooted in 16th century mercantilist dogma. It demands policies that are welcoming of imports and foreign investment, and that minimise regulations or administrative frictions that are based on misconceptions about some vague or ill-defined "national interest".

To nurture the promise of our highly integrated global economy, governments should stop conflating the interests of certain producers with the national interest and commit to policies that reduce frictions throughout the supply chain – from product conception to consumption – as well as in the flow of services, investment and human capital.