The Failed Expectations of U.S Trade Policy

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As the principal negotiator for the landmark market access agreement that led to China's accession to the World Trade Organization (WTO), I have reflected on whether the agreements we negotiated really lived up to our expectations. A sober reflection has led me to conclude that those trade agreements did not.

We failed to address the underlying fundamental market distortions that skew the benefits toward the few while leaving the rest of the economy less well off. As George Soros, in a Bloomberg News interview on the financial crisis, recently said, "…the system, as it currently operates, is built on false premises." The premise on which our trade agreements are negotiated is at best flawed, if not broken.

The next administration has to take a hard look at the trade agreements currently on the table – especially with South Korea – and ask: who benefits? The answers should lead to a fundamental reassessment of what needs to be included in those trade agreements so that the benefits flow to broader and more equitable segments of the economy.

Failed Expectations

China's agreement to enter the WTO is a perfect example of failed expectations. In order to join the WTO, China made unilateral concessions to reduce and, in some cases, eliminate barriers to entry for U.S. goods and services. While no one claimed that the bilateral deficit would be reduced, claims were made that U.S. exports of goods to China would increase thus creating jobs in the higher paying export sector.

U.S. exports to China have increased and, as the U.S. Trade Representative (USTR) often emphasizes, at a higher rate than to any other country. But such claims distort the real truth that exports grew faster because they grew from a very low level. In absolute terms, the increase in U.S. exports of goods to the EU was almost 70% greater than the increase in exports of goods to China and to Canada; the increase was 40% more than to China. Neither of those trading partners made any trade concessions to the United States during this period.

Conversely, on the U.S. import side, the United States made no concessions to China, yet U.S. imports from China were more than triple the pre-accession levels; to $321 billion in 2007, almost matching imports from the entire European Union. In contrast, increases in imports from Canada, our largest trading partner, rose by $82 billion and imports from the EU increased by $134 billion.

Who Benefits?

The beneficiaries of the agreement with China fall into two groups: multinational companies that moved to China and the financial institutions that financed those investments, trade flows, and deficits. Foreign direct investment (FDI) in China accelerated at a time when such investment to other parts of Asia was declining and, in 2001, even matched FDI to the United States. Sourcing from China, whether from direct investment or through licensing arrangements, has allowed companies to cut costs and increase profits, as reflected in increased corporate profits and the surge in the U.S. stock market.

Conversely, it is doubtful that the U.S. economy or its workers are better off. U.S. manufacturing jobs declined by more than 2.5 million since China joined the WTO in 2001. While services jobs increased during this period, with the exception of telecommunications, non-tradable jobs accounted for the most significant portion of that increase. Wages have been stagnant and real disposable income for three-quarters of U.S. households has been stable or declining. Only the top quartile of families has seen significant increases in real disposable income.

The beneficiaries of these trade agreements try to divert attention by arguing that our trade in services has increased or that our competitiveness has declined. Those arguments are simply diversions because they don't explain why our exports of goods to countries that made no concessions increased more than our exports to China, which made significant tariff and non-tariff concessions. Such arguments also fail to explain why our imports of goods from China increased more than our imports from other major trading partners. Is there any wonder that the people on Main Street think that trade agreements do not work?

Broken Premises

Were this simply a problem with our bilateral trade relationship with China, policy makers could focus on resolving that dysfunctional relationship. However, the problem extends to nearly all trade agreements since they are based on the flawed premise that free trade benefits the economy. The premise is flawed and broken since free trade does not exist in a "free market" Petri dish where all other factors are neutral.

Using China as an example once again, proponents of the free trade model argue that China has a competitive advantage in wage rates that makes it ideal as the global manufacturing center that it has become. A closer examination, however, reveals that China has adopted an export-led development strategy, the centerpiece of which is a currency that is undervalued by 20-80%, with the consensus leaning toward 40%. Thus China's wages, in U.S. dollar terms, are 40% cheaper than they would have been if the currency were allowed to freely float. Similarly, foreign investors receive a 40% subsidy to develop operations in China. To add insult to injury, our exports are taxed at an additional effective 40% rate.

While China has been appreciating its currency, it has a long way to go to bring it to equilibrium levels. In addition, China's internal barriers to trade not only restrict U.S. exports, but also restrict China's market to Chinese producers, thus reducing the size of the domestic economy. It's no wonder that, until the last few months, our imports from China continued to accelerate, jobs continued to move overseas, and our exports to China consisted primarily of raw materials. The weakened U.S. dollar has only recently had a positive impact on U.S imports. Europe, Canada, and other countries with freely floating exchange rates face comparable trends in their trade relationship with China.

Similar arguments can be made for our "free trade" agreements. For example, Canada fosters oligopolies and in some provinces, monopolies that restrict both foreign trade and internal trade. Like

China, South Korea, which recently concluded its FTA with the United States, has notoriously undervalued its currency, as automakers will attest. In addition, most countries have value-added taxes that are rebated on their exports to the United States, while our exports receive no such treatment because our federal tax system relies on income and corporate taxes.

While these restrictive policies have little or no effect on our free trade agreements with many of the smaller economies, they do have a significant negative impact on our agreements with the larger economies. While focus has been placed on labor and environmental standards, until and unless we are able to also incorporate factors such as currency undervaluation and the lack of competition policy into our trade policy, the premise of “free trade” will fail to deliver its promises, whether delivered by Democrats, Republicans, or both.

With the current financial and recessionary crisis, many “traditionalist” thinkers will likely pull out the old premises, arguing to conclude the Doha Round and pass legislation enacting recently signed free trade agreements as a means of alleviating the crisis. Once again, multinational companies and financial institutions and their think tanks will lead the charge since they would be the primary beneficiaries. Before we blindly accept trade agreements that will simply result in lost jobs, the next administration needs to also comprehensively address the disparities in international monetary and competition policies that prevent our trade agreement from delivering the results that Main Street was promised and deserves.

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