



How Can Trade Policy Help America Compete?

Robert Z. Lawrence

Robert Z. Lawrence has been a senior fellow at the Peterson Institute since 2001 and is also the Albert L. Williams Professor of International Trade and Investment at Harvard University. He was a member of the Council of Economic Advisers from 1999–2001. He is author or coauthor of *Blue-Collar Blues: Is Trade to Blame for Rising US Income Inequality?* (2008), *Case Studies in US Trade Negotiation* (2006), *Anchoring Reform with a US-Egypt Free Trade Agreement* (2005), *Has Globalization Gone Far Enough? The Costs of Fragmented Markets* (2004), *Crimes and Punishment? Retaliation under the WTO* (2003), and *Globophobia: Confronting Fears about Open Trade* (Brookings Institution Press, 1998).

Note: This paper was originally prepared for Harvard Business School's Project on US Competitiveness. I am grateful to C. Fred Bergsten and Michael Porter and participants in the meeting held at Harvard Business School in November 2011 for comments.

© Peter G. Peterson Institute for International Economics. All rights reserved.

America deserves credit for not having succumbed to the global financial crisis by repeating the protectionist mistakes of the 1930s. Nonetheless, since 2007, although lip service has been paid to boosting US exports, its trade policy accomplishments have been modest. This is unfortunate because active trade policies can promote American living standards and facilitate America's return to full employment and sustained growth. These policies can also help to create a global trade order that advances American interests. In this brief I argue that the United States needs new initiatives that discipline foreign practices, increase access to foreign markets, revitalize the World Trade Organization (WTO), improve the administrative and regulatory environment for trade, and assist workers and communities adversely affected by change.

America has traditionally provided leadership in WTO and multilateral trade negotiations but the current talks, the Doha Round, are moribund and US leadership conspicuously absent. In the past, the United States has been active in negotiating bilateral free trade agreements, yet the United States dallied until late 2011 before ratifying the three agreements that had already been concluded by the Bush administration by mid-2007. The United States was similarly tardy in launching its two current significant free trade agreement (FTA) initiatives—The Trans-Pacific Partnership and Transatlantic FTA—and even now, since the President's Trade Promotion Authority expired in 2007, those negotiations have no congressional mandate. The United States has also historically been an aggressive defender of its rights under existing agreements. And while five cases were brought to the WTO in 2012, in the three prior years, only seven cases were launched—a number equal to the annual average recorded between 1995 and 2008. In contrast to the United States, other major trading countries speedily responded to the impasse in the Doha Round by energetically negotiating new free trade agreements. The European Union, Japan, and China and India are all actively signing new bilateral deals and participating in multi-nation regional initiatives.

Viewed from a political perspective, placing trade on the policy backburner has been understandable. In an economically desperate and a highly partisan environment, the administration preferred to spend its scarce political capital on domestic priorities such as healthcare, financial reform, economic stimulus, and the budget. In addition, to promote an active trade agenda, it has to convince a public that has become increasingly skeptical about the benefits of open trade in general, and trade agreements in particular. Indeed, although the original financial crisis was made in the USA, Americans often blame their current difficulties on the global economy. Many contrast the booming growth in emerging markets such as China and India over the past decade with a domestic economy that has had large trade deficits, lost 6 million manufacturing jobs, and seen no rise in real wages. A majority of the public believes that while other countries

have derived benefits from the trade agreements they have signed with the United States, Americans have been harmed. Remarkably, the *Wall Street Journal* reported in 2010 that over 50 percent of well-educated and upper income Americans (those earning \$75,000 a year or more)—a group that had previously strongly supported new trade agreements—now concur with this view.¹

A majority of the public believes that while other countries have derived benefits from the trade agreements they have signed with the United States, Americans have been harmed.

While understandable, the contrast between the lethargy in the United States and the energy displayed by other countries is unfortunate. Trade policy has a vital role to play in helping America meet its adjustment challenges and promoting its long run economic interests. Indeed this was recognized by President Obama when he set the goal of doubling US exports in five years in his 2010 State of the Union Address. This is indeed a worthy objective—since it could contribute significantly to job creation in the recovery.

US exports can be boosted by a weaker dollar or increased investment that makes US goods and services cheaper, more attractive, or more prominent. But all these measures are costly. A weaker dollar raises the costs of buying foreign products, while innovation, investment, and trade promotion all require additional resources.

By contrast, policies that open foreign markets can boost the demand for US products without additional outlays by Americans. They provide US firms more opportunities to make sales of products they already produce without having to reduce their prices. They make the United States a more attractive location to source exports and thus also provide incentives for firms to invest more in the United States. Many of America's innovative achievements need to be protected with patents and copyrights, and thus improved enforcement of US intellectual property rights abroad can also raise US incomes and stimulate additional investment and innovation.

How can these benefits be reaped? The United States cannot impose its will on others, but needs to act bilaterally and collectively to construct and maintain a trading order

that supports its economic interests. This is increasingly challenging in a global system in which large emerging economies are becoming more influential over time.

Emblematic of the trade policy challenges for the United States in constructing a new order are those associated with China. Historically, global leadership has been provided by so-called hegemonic economies—such as Great Britain in the 19th century and the United States in the 20th—that were both large (especially when Britain's empire is taken into account) and rich and therefore could afford to think and act systemically. But the problem presented by China is that it is large enough to be globally important and yet it is still poor.

Relative to the United States in per capita income, China stands today where Japan stood relative to the United States in 1950. Its per capita incomes are a tenth of those of the United States measured in (current) dollars and about a fifth by purchasing power (Heston, Summers, and Aten 2011). This view is sometimes challenged by pointing to China's huge foreign exchange reserves and trade surpluses even in products classified as high-tech. But China's current strength in trade is exaggerated because it only assembles these products by using intermediate products and designs that are produced elsewhere (Linden, Kraemer, and Dedrick 2009). In fact, China's specialization patterns and the prices of its products are quite typical of a developing country (Edwards and Lawrence 2010).

In some respects, the Chinese market is fairly open. Chinese tariffs average 10 percent and it has generally been hospitable to foreign investment, especially firms producing for export. But to promote its development, China also has an extensive array of measures designed to encourage domestic innovation and production that are an increasing source of friction with its trading partners. These involve an undervalued currency, subsidies such as cheap energy, strategic use of state owned enterprises, preferential government procurement to promote indigenous innovation, investment restrictions in certain sectors, technology transfer requirements, and measures to reserve key raw materials such as rare earths for domestic use. Copyright, trademark, and other intellectual property violations are also widespread.

As with all great economic powers, China must create a political superstructure that supports its needs. China must weigh whatever benefits its policies might provide domestic firms against the costs its protectionist behavior imposes on China's ability to engage globally. China needs open markets for its exports, abundant supplies of foreign raw materials and intermediate inputs that are not produced domestically, and opportunities for its firms to invest abroad. China has tried to secure these through diplomacy, aid, and numerous free trade agreements and cooperative arrangements with other coun-

1. In 1999, only 24 percent of Americans earning more than \$75,000 were skeptical about trade's benefits. "Americans Sour on Trade," *Wall Street Journal*, October 4, 2010, page 1.

tries. A key element in China's strategy has been its membership in the WTO. In 2001, the United States supported Chinese accession to the WTO but only when it agreed to tough conditions for market opening. And both China and the United States have benefitted as a result. The United States needs to learn from this success, and build on it.

US exports can be boosted by a weaker dollar or increased investment that makes US goods and services cheaper, more attractive, or more prominent. But all these measures are costly....By contrast, policies that open foreign markets can boost the demand for US products without additional outlays by Americans.

I've used China as an example, but the United States faces similar challenges in many other large emerging markets such as India and Brazil. The United States should not try to inhibit emerging country growth—indeed it can benefit from their prosperity (Edwards and Lawrence forthcoming); nor should it try to dictate the domestic policies of these countries. US policies should create incentives for these countries to adopt policies which minimize discrimination against foreign products and firms, thus nudging them in the direction of other nations that have successfully achieved global leadership. These US policies should have multilateral, regional, and bilateral dimensions.

The WTO should be useful for this purpose. It is the major forum for relationships with America's largest trading partners such as the European Union, Japan, China, India, and Brazil, with whom the United States has not signed free trade agreements. US engagement needs to be more active, both in bringing cases to enforce its rights under existing agreements, and in negotiating for new rules that improve market access.

DISPUTES

The WTO dispute settlement system has been quite effective. WTO rules constrain protectionist behavior, discipline the use of subsidies, prohibit the use of discriminatory regulations, and require enforcement of intellectual property protection. Its multilateral nature helps secure its legitimacy and thereby reduces the political and diplomatic costs associated with bilateral disputes. It not only provides mechanisms for resolving

disputes but also for retaliation within prescribed bounds when compliance cannot be achieved. Since large countries such as China, the United States, and the European Union have an interest in the system, their records in coming into compliance when found in violation has generally been quite good

The United States needs to be more active in using the system. The problems faced by US firms when they compete internationally are often similar to those faced by firms from other countries. Indeed the list of complaints voiced by Europe when it comes to China for example, is virtually identical to that of the United States. The United States, European Union, Mexico, and other countries have joined in bringing a few cases, most notably recently on the issue of China's embargoes on exports of rare earths, but their efforts should be more concerted and coordinated.

There are legal tools for private firms to bring cases against unfair foreign practices that occur in the US markets such as dumping, subsidies, and intellectual property violations, but abroad the firms depend more heavily on the US government to promote their interests. Private firms and organizations do not have the right to bring cases at the WTO so dispute settlement is an area in which the private sector has to work hand in hand with the government. Thus the barriers in foreign markets and practices that confront private firms have to be communicated to the US government so that their removal can be sought. US firms and business organizations should be more pro-active in generating these cases.²

NEW AGREEMENTS

The WTO can in principle be used to further reduce barriers and discriminatory treatment in trade. But the system is in trouble because the Doha Round is at an impasse. Dubbed the Doha Development Agenda, it was meant to promote the interests of developing countries and was centered on agriculture. There are however many other issues on the table and all are part of a single undertaking in which "nothing is agreed until everything is agreed." Launched in 2001, the Round was supposed to end in 2005. Given the number and diversity of the members, the practice of requiring consensus for all decisions, and the complexity of the package, it is no wonder that every deadline has been missed.

These delays have been costly because the world has changed. The prioritization of agriculture was questionable from the start, (the payoffs in reducing industrial tariffs and

2. Gary Hufbauer of the Peterson Institute for International Economics has advocated granting a private right of action for firms to bring cases similar to that provided in investment disputes. This is a proposal worthy of serious consideration.

liberalizing services are much larger) and has become increasingly problematic. In 2001, global food prices were low and the major issues were import barriers and subsidies to production in developed countries. These problems remain, but in 2012, global food prices are high and volatile, and the key farm trade issue not covered by the talks is the export restraints imposed

If China acted as a leader in the trading system it would be recognized as one.

by many developing countries. In 2001, China was a newly acceding member that needed time to adjust and many developing countries in Africa and Latin America had experienced two decades of slow growth. But now China is the world's largest exporting nation, and many developing countries have enjoyed a decade of unprecedented growth. US priorities in the Round—obtaining meaningful market-opening concessions from the large emerging economies—have been hard to achieve since developing countries have acted as a block to limit their concessions. From a US vantage point, the bargain that is on the table looks small and uncertain (Schwab 2011).

Increasingly there are calls for the members to terminate the negotiations by admitting failure or by harvesting the concessions that have already been made. But failure would damage the system, while harvesting gains is problematic, since offers were made on the assumption that additional concessions would be forthcoming. Ideally, the largest members would step forward and exercise the leadership needed to reach a meaningful agreement. China and the United States and European Union would put additional offers on the table. Among these offers, China would join the WTO's Government Procurement Agreement, and bind the provinces as well as the central government. This would ensure that foreign products enjoy non-discriminatory treatment and it would reduce foreign concerns about China's controversial "indigenous innovation" program. China would also volunteer to join sector liberalization agreements in chemicals, electronics, and environmental goods and services. Finally, China would be at the front of talks to liberalize services, not dragging the rear. These would be widely recognized as new and meaningful concessions. If China acted as a leader in the trading system it would be recognized as one. In return for Chinese concessions, the United States and other developed countries would grant China recognition as a market economy, with normal remedies in anti-dumping and safeguard cases, and also put an end to the annual compliance review that China agreed to when acceding. If the United States

and China were on board, other major players will feel pressure to contribute. India, with its great interest in maintaining open markets in information services would join the services talks and also sign on to the Government Procurement Agreement. Brazil and other successful developing countries would do likewise and contribute concessions on industrial products.

Unfortunately, however, while desirable, and indeed feasible, this scenario is unlikely. China, clearly the lynchpin in this type of agreement, has preferred to position itself as a poor country rather than a global leader with systemic interests. As a result, the concessions already agreed to for the least developed countries and the agreements on trade facilitation that relate to transit trade, limiting border fees and formalities and making trade policy information more transparent, may never be adopted.

BEYOND DOHA: A VARIABLE GEOMETRY

The challenge with the Doha Round impasse is how to revitalize the WTO. An alternative approach to multi-issue Rounds is to proceed separately with specific issues, but not require all members to join. This has already begun with the launch of negotiations for a plurilateral agreement on services by several WTO members.

These agreements make sense. WTO members are diverse and one size does not fit all. Instead of a system in which all members, both developed and developing, are required to adhere to all rules, a more attractive approach would entail a variable geometry with mandatory core commitments supplemented by plurilateral agreements to which only some members belong. These agreements could take a variety of forms. They could involve new rules, the full liberalization of sectors, and agreements on trade facilitation. Some could extend most-favored-nation treatment to all members, others only to those who sign up. Some could become binding on members only when a critical mass sign up (Lawrence 2006).

This approach would end the simplistic distinctions between developed and developing countries and allow members from both groups to adopt rules that met their interests. Examples might include foreign investment, rules for state-owned enterprises, restrictions on export barriers, restrictions on energy subsidies, competition (anti-trust) policies, regulatory practices, customs procedures, additional intellectual property protection, and rules of origin in preferential trade arrangements. Willing countries might also deal with issues such as labor and environmental standards through this mechanism.

FREE-TRADE AGREEMENTS

The WTO plays an essential role at the heart of the trading system. It is the only forum for effectively dealing with issues such as farm subsidies, which need to be negotiated multilaterally to avoid some countries free riding on the reductions of others. But the diversity of its membership—there are over 150 members at vastly different stages of development—makes it difficult and indeed inappropriate to reach agreements that apply equally to all. By contrast free-trade agreements between pairs or groups of trading partners offer opportunities for deeper integration between countries that may be better suited to their needs. They also offer opportunities to demonstrate the feasibility of new approaches to trade, and can effectively promote pressures for competitive liberalization.

The prototypical agreement signed by the United States for example has included the removal of almost all border barriers between the partners, full liberalization of services unless explicitly exempted, strong intellectual property protection, liberalization of foreign direct investment, government procurement liberalization, enforcement of core labor rights and environmental standards, and numerous other regulatory provisions.

While it has evolved over time—in particular the provisions on labor rights have become more demanding—the United States has generally insisted on a template, partly because making concessions in one agreement could set a precedent for those that follow, and partly because the template has been crafted to maximize the chances of the needed congressional ratification. These agreements have been successful in forging deeper links between the United States and compliant and generally small trading partners. However, they have yet to prove their usefulness either for linking larger groups of countries together or for concluding bilateral agreements with large and more significant trading partners. Indeed, US efforts in the 1990s to conclude a single hemispheric agreement for Free Trade in the Americas ended in failure.

The Trans Pacific Partnership (TPP) negotiations offer an important opportunity to develop a model that can be effective both in dealing with deeper integration issues and in providing mechanisms that make it relatively easy for additional countries to join. In particular, if the United States can lead in creating an effective and integrated environment for the operation of regional supply chains, that could enhance the competitiveness of all participants and put pressure on other countries in the Pacific and elsewhere to offer similar opportunities. But it might take a willingness on the part of the United States to move away from the rigid approaches it

has insisted upon in other agreements. One example relates to developing common and simple rules that would allow participants to cumulate value-added in any country in the group to qualify for duty-free entry.

Major partners bring far more to the table, but are also likely to demand more flexibility on the part of the United States. A comprehensive deep integration agreement with the European Union for example, that covered issues that are not dealt with in the WTO (such as investment, mutual recognition of regulations, and additional intellectual property rules) would be especially meaningful but the European Union would resist including agriculture. India is involved in talks with the European Union and has an agreement with Japan. It would also be a very attractive partner for an agreement but would strongly reject the inclusion of labor and environmental standards and demand liberalization for professional services providers. Deviating from the blueprint could involve political costs, but these need to be weighed against the potential strategic and economic advantages of agreements with these larger countries. Absent making such concessions that United States could find its exporters further disadvantaged.

TRADE FACILITATION

Trade can be promoted not only by removing border barriers but by reducing transactions costs imposed by customs, transportation, logistics, regulations, and security procedure. The World Economic Forum captures all these elements in its annual Global Enabling Trade Report and the United States has been doing poorly and falling behind, ranking just twenty-third in 2012 compared with fourteenth in 2008—indicating considerable room for improvement. The United States performs poorly in its border administration, government efficiency, and regulatory environment. There is scope for improvement on these issues, both unilaterally and in cooperation with trading partners. US firms that engage in trade are heavily affected by these measures and the US government should set up more effective feedback mechanisms so that it can work with these firms to give them the public services they require to succeed.

ALLEVIATING OUTSIDE PRESSURES ON THE SYSTEM

The global trade system has weathered the financial crisis better than might have been expected. But there are threats that come from policy initiatives that, if not taken care of, could seriously

undermine the system. The first relates to the macroeconomic issues of global imbalances and the associated question of undervalued exchange rates. This is an issue which obviously affects the trading system, but the trade rules do not provide appropriate mechanisms for dealing with it. It is highly doubtful for example, that maintaining an undervalued currency would qualify as a subsidy that violates WTO rules and certainly the case that that institution is not well equipped to deal with the issue. Instead, it should be pursued in organizations with greater competence on macroeconomic issues, such as the International Monetary Fund (IMF) and the G-20.

As China has acknowledged, it needs to shift away from growth led by foreign demand for its exports and domestic investment in heavy industry and construction towards growth driven by higher wages and increased consumer spending. A stronger renminbi is necessary but not sufficient to accomplish this change smoothly. A host of complementary social and fiscal policies need to be implemented to facilitate the adjustment. The United States not only has an interest in China adopting these policies, but also that they are successful.

The second relates to climate change. The appropriate response here is a comprehensive climate change agreement negotiated through the United Nations Framework that eliminates the need for border measures. But like the Doha Round, that initiative is also moribund. Some countries that have adopted measures to deal with climate change have argued that it is necessary to prevent leakage and/or adverse competitive effects by imposing taxes and other charges at their borders. These are however second best responses that raise knotty problems for the trading system.

ADJUSTMENT ASSISTANCE

Displacement and job loss are extremely painful and costly experiences for workers. Import competition contributes but it is by no means the most important. Even in years when the US economy is at “full employment” there are 20 million experiences of workers being laid off involuntarily. (There are an astounding 60 million departures overall). An upper bound estimate (Edwards and Lawrence forthcoming) that assumes every import leads to displacement of an American worker suggests 3.6 million jobs lost over a decade! This implies that imports account for less than 2 or 3 percent of overall involuntary displacement.

The US unemployment system was designed in the 1930s. Improved adjustment assistance programs are needed.

A new American Adjustment Program should combine the best elements of unemployment insurance, Trade Adjustment Assistance, and training programs authorized by the Workforce Investment Act into a unified approach: a wage-loss insurance program for workers 45 and older, to speed their rehiring by supplementing their income if they take work at lower pay; helping pay for COBRA coverage (which allows workers who lose their jobs to continue group health benefits for limited periods) for workers while they receive unemployment insurance; and enabling unemployed workers to make penalty-free withdrawals from 401(k)s and Individual Retirement Accounts (IRAs) to finance costs like occupational retraining and relocation. While some of these elements are already part of the existing Trade Adjustment Program, its scope is far too limited for the needs of a 21st century workforce.

CONCLUDING COMMENTS

I have argued that trade policy needs to given more attention because it offers opportunities to assist the United States meet its adjustment challenges and raise its living standards and have offered some specific suggestions for how trade policy could be revitalized. I end with a qualification and a warning.

Trade policies are not a panacea. While trade agreements can create new opportunities they do not guarantee results. But trade policies are an important complement to the other measures needed to enhance US competitiveness and facilitate domestic adjustment. Inventing new products is of little use if others feel free to copy them without compensation. Making goods and services more attractive is of no avail if market access is denied. Efforts to promote investment in the United States by either foreign or US owned firms will be hindered if firms located in the United States do not enjoy the access to foreign markets provided to firms based in other countries.

An alternative US strategy could be to raise domestic barriers in an effort to generate more demand for US production through import substitution. Instead of seeking to ensure that foreign countries play by the rules, the United States could break them on the grounds that others are cheating. But erecting higher barriers at home would be misguided, impractical, and unwise. Misguided because there are substantial gains from trade; impractical because the intertwining of domestic and foreign production in supply chain networks makes withdrawal difficult and costly; and unwise because it could set off foreign retaliatory responses that could endanger the recovery and make everyone worse off.

REFERENCES

- Edwards, Lawrence, and Lawrence, Robert Z. Forthcoming. *Rising Tide: Is Growth in Emerging Economies Good for the United States?* Washington: The Peterson Institute for International Economics.
- Edwards, Lawrence, and Lawrence, Robert Z. 2010. *Do Developed and Developing Countries Compete Head to Head in High-tech?* National Bureau of Economic Research Working Paper No. 16105. Cambridge, MA: National Bureau of Economic Research.
- Heston, Alan, Robert Summers, and Bettina Aten. 2011. Penn World Table Version 7.0. Center for International Comparisons of Production, Income, and Prices at the University of Pennsylvania.
- Lawrence, Robert Z. 2006. Rulemaking Amidst Growing Diversity: A Club of Club Approach to WTO Reform and New Issue Selection. *Journal of International Economic Law* 9, no. 4 (December).
- Linden, Greg, Kenned L. Kraemer, and Jason Dedrick. 2009. Who Captures Value in a Global Innovation Network? The Case of Apple's iPod. *Communications of the ACM* 52, no. 3: 140–144.
- Schwab, Susan. 2011. After Doha: Why the Negotiations are Doomed and What to do About It. *Foreign Affairs* (May/June).

The views expressed in this publication are those of the author. This publication is part of the overall programs of the Institute, as endorsed by its Board of Directors, but does not necessarily reflect the views of individual members of the Board or the Advisory Committee.