The Global Trading System: What Went Wrong & How to Fix It

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Introduction

It has now been more than a quarter century since the United States, the European Union (EU), Japan and more than 100 other countries came together to conclude the Uruguay Round global trade agreement and establish the World Trade Organization (WHO). It was a time of extraordinary optimism. Mickey Kantor, US trade representative for President Bill Clinton, had endured many sleepless nights with his counterparts to bring the deal home by the Dec. 15, 1993 deadline. He promised the new agreement would “raise the standard of living not only for Americans, but for workers all over the world”. Every American family, he said, would gain some $17,000 over the next decade from lower-cost imports and faster global growth. For the world, the end of the US-Soviet rivalry and the dawn of a new era of economic cooperation would “turn mutual assured destruction into mutual assured prosperity”. He recounted the errors of the past, when the US after World War I had turned inward and protected its economy with high tariffs, causing other countries to do the same in a cycle of beggar-thy-neighbor protectionism that deepened the Great Depression. Now instead, he said, the world was on the cusp of a new era of growth led by “the historic engagement of the United States”.

That halcyon moment now seems part of a distant past. The Uruguay Round would be the last major global trade agreement concluded – the seventh in a series reaching back to the establishment of the General Agreement on Tariffs & Trade (GATT) in 1947. The Doha Round launched in 2001 was quietly buried in 2015, a victim of insurmountable disagreements among the US, Europe and the rising developing countries like India and China. China’s entry into the WTO in 2001 would trigger a surge of exports that contributed to the loss of well-paid manufacturing jobs in the US, Europe and elsewhere, helping to fuel a populist backlash against globalization. And in 2016, voters in those US states hit hardest by trade competition – Ohio, Pennsylvania, and Michigan – would hand the presidency to Donald J. Trump, an avowed economic nationalist. In his first two years in office, President Trump pulled the US out of the massive Trans-Pacific Partnership (TPP) trade deal with a dozen Pacific Rim countries, and launched a flurry of tariff protection measures unseen in the US since the Smoot-Hawley bill in 1930. Most other countries responded in kind.

The international economic order is now at a turning point. The trade skirmishes of the last two years could be merely the first acts in what will become a prolonged era of growing nationalism and protectionism. Gideon Rachman, the *Financial Times* columnist, has argued that the nationalist backlash symbolized by Trump’s election and the 2016 Brexit vote in the United Kingdom is likely to spread to other countries and persist for several decades. But, he noted, those movements will have to show that they can deliver not just promises but real economic results. So far – as the process of the UK government and parliament’s efforts to leave the EU show – real economic results have not been delivered. But champions of globalization and the “rules-based trading system” cannot simply wait and hope that the failures of economic nationalism will become evident. They will have to acknowledge their own failures over the past several decades, and demonstrate that they can deliver where the economic nationalists cannot in spreading the gains of globalization more broadly.

Global Governance & Global Gains: What Went Wrong?

For nearly a decade, it looked like Kantor’s rosy optimism about the mutual benefits from global trade would not be far off the mark. American households did not see the promised $17,000, but by the turn of the century the annual median household income had risen by nearly $8,000 to more than $60,000 as the US economy enjoyed the fruits of the information technology revolution and growing trade. The rest of the world benefited as well. In the two decades leading up to the 2008 recession, more people were raised from extreme poverty than in any other period in human history, mostly those in China and India.

But the “win-win” story did not last long. The creation of the WTO had coincided with, and reinforced, a technological earthquake that would turn more than 150 years of global economic history on its head. As economist Richard Baldwin lays out in his book *The Great Convergence*, the Industrial Revolution of the 19th century had launched Europe, the US, Japan and Canada on a trajectory that would see their wealth surge ahead of the rest of the world. In 1820, for example, incomes in the US were about three times those of China; by 1914 Americans would be 10 times as wealthy as Chinese. Manufacturing clustered in the technologically advanced countries, while advances in containerized shipping and the lowering of tariffs through trade negotiations made it possible for these countries to specialize and trade in the classic Ricardian fashion.

The information technology revolution of the 1990s turned that story upside down. With the advent of cheap, virtually instant global communications via the Internet, it became possible – and then imperative for competitive success – for multinational companies to take their best technologies and relocate production in lower-wage countries. Manufacturing output rose in middle-income countries like China, India, Thailand, Poland and others, while falling sharply in the US, Japan, France, the UK and even Germany. Most developing countries – which had been reluctant participants in the Uruguay Round negotiations – abandoned decades of protection and began opening up to attract global investment and win their share of the growing pie. Bilateral investment treaties – which protect foreign investors against various forms of expropriation – proliferated, with hundreds of new deals negotiated in the 1990s. The most important accomplishment of the Uruguay Round was not its continued incremental tariff cuts, but the new rules to protect intellectual property, which allowed multinational companies to expand operations overseas with greater assurance that their technologies would not be stolen by competitors.

All of this should have been good news for the world. The rapid growth of the developing economies was a long overdue catching up with their wealthier counterparts. And while growth was comparatively slower in the advanced economies, they had continued to see modest gains. According to the World Bank, global wealth increased by nearly two-thirds from 1995 to 2014, to more than $1.1 trillion. The share going to middle-income countries such as China and India grew from 19% to 28%, while the advanced economies of the West saw their share fall from 75% to 65%. But there was still more than enough to go around, and the average American is still five or six times wealthier than the average Chinese.

The global great convergence, however, coincided with a great divergence within the wealthy countries (and many developing countries as well). The new technologies and the disappearance of trade barriers upended the balance between labor and capital in the advanced industrialized countries, and contributed to soaring economic inequality. In the early 1960s, the US labor leader George Meany had been one of the country's great champions of trade liberalization, arguing that freer trade would "contribute to the growth of employment and improvement of living standards at home and abroad". Within a decade, however, the unions had reversed course, recognizing that global investment by US companies was changing the balance of power at home that had allowed unionized workers to bargain for higher wages. Where once the giant American companies had little choice but to share their gains with the workforce, now they had enormous leverage – workers who insisted on more could be replaced, either by cheaper workers overseas or by machines at home. Where wages had once advanced in lockstep with rising productivity, companies began to take home more in profits and workers saw less in their paychecks.

The new information technologies themselves reinforced this rising inequality. As machines replaced workers – not just in manufacturing but increasingly in office jobs of every sort – the need for highly educated workers rose. In the US in 1979, an American with a college degree or higher earned about 50% more than one who had only a high school education or less. By 2018, American workers with a four-year college degree earned almost twice as much as those with just a high-school education, and were unemployed half as often, while those with a professional degree earned nearly three times as much. The trends have been similar in all the advanced economies, with the earnings premium from education rising sharply. In many countries, however, higher taxes on the wealthy and government programs for redistribution have softened the blow. It is no coincidence that the two advanced economies that have seen the greatest rise in after tax income inequality – the US and the UK – are the ones that have seen the strongest public backlash against globalization.

Irresponsible Stakeholders

Most of the blame for this state of affairs lies with politicians in the advanced economies. It has been evident for decades that the growth in global economic competition would require adjustments to domestic economic policy to ensure that the benefits of global growth were spread more evenly. In my book *Failure to Adjust*, I quoted extensively from a memo written to President Richard Nixon in 1971 by his chief international economic advisor, Pete Peterson. Peterson warned the president that, as global economic competition increased, the US would have to up its game by investing in infrastructure, maintaining the best education system in the world, and funding retraining and assistance for workers who lost their jobs to imports or automation. Instead, beginning with the Ronald Reagan administration in the early 1980s, the US has focused primarily on reducing the tax burden on the wealthy, paying too little attention to the challenge of helping Americans adjust to an increasingly competitive economy.

But it is also true that the countries that were benefiting the most from the new globalization, especially China, have been slow to wake up to what the changing balance of global economic power meant for their position in the system. The two golden eras of global commerce – in the latter half of the 19th century and again in the latter half of the 20th century – occurred under rules that were largely established by a dominant economic power: the UK in the 19th century and the US in the 20th century. Charles Kindleberger, who wrote the seminal book on the causes of the Great Depression, argued that the downturn was worsened by a fading UK's inability to manage the global economic system, and the unwillingness of the US to step up and play a bigger role.

The world today again faces the same governance gap – a US that no longer has the economic muscle nor the political will to organize the global system, and a rising China that is reluctant to play a greater role. Indeed, for most of the period since joining the WTO, China has sought maximum economic advantage with minimum regard for the rules and obligations of WTO membership. It has heavily subsidized industry after industry, used discriminatory regulations to disadvantage foreign companies and favor its own national champions, and engaged in a broad campaign of technology acquisition using every tactic from forcing foreign investors to share technology with Chinese competitors to outright cyber-theft. And for many years it intervened in currency markets to hold down the value of its currency, the renminbi, to gain competitive advantage. These are the issues at the heart of the ongoing trade dispute between the US and China.

The US, as well as Europe and Japan, can certainly be blamed for not responding sooner and more forcefully to these Chinese provocations. It wasn't until the second term of the Barack Obama administration that the US moved beyond the occasional WTO complaint and finally initiated a slew of WTO dispute settlement cases to go after the growing list of the problems with China. In retrospect, the US took a gamble in treating China so delicately. In 2005, for example, former US Trade Representative and then Deputy Secretary of State Robert Zoellick gave a speech urging China to become a "responsible stakeholder" and work "to strengthen the international system that has enabled its success". But he warned: "The United States will not be able to sustain an open international economic system – or domestic US support for such a system – without greater cooperation from China as a stakeholder that shares responsibility on international economic issues."

He was right. Since the election of Trump, the US has all but abandoned its post-World War II role as the chief architect and guardian of the rules-based trading system. The Trump administration has embraced a zero-sum view of the global trade system, using tariffs as a weapon to block access to what is still the world's largest market and try to force trading partners from Canada and Mexico to South Korea, Japan and the EU to renegotiate long-standing trade arrangements in ways designed to shift investment to the US. With China, the administration has engaged in an aggressive effort to block China's drive for technological parity with the US. It has largely shut off Chinese acquisitions of American companies on security grounds, and is pressuring US allies to restrict transactions with Chinese high-tech companies such as Huawei and ZTE. Some administration officials are pushing for a deeper de-coupling of the US and Chinese economies, reminiscent of the economic containment strategy pursued against the Soviet Union during the Cold War.

Better Globalization: Is There a Blueprint?

If history is a guide, there is every reason to believe that disputes over the relative gains from the global economy will worsen. Both the US and China are likely to dig more deeply into their respective corners. Under President Xi Jinping's leadership, China has been funneling more resources to state-owned enterprises, interfering more deeply in the management of foreign enterprises, and using its economic muscle to influence the behavior of smaller countries. Pressure from the US is likely at best to lead to a tactical pause rather than a change in direction. In the US, concern over China's economic practices and its increased global assertiveness is shared among both parties. Future presidents, either Democratic or Republican, are unlikely to embrace the more unconditional engagement of the former administrations of Obama and George W. Bush.

The great power rivalry will force smaller countries to look out for their own narrow economic advantages through new bilateral or regional trade arrangements. The recent EU trade agreements with Mexico, Canada and Japan – as well as the decision by the other members of the TPP to move forward without the US – are signs of this Plan B in action. But these middle powers are also the countries with the most to lose from the weakening of the rules-based trading system and the return to great power economic competition. The WTO's dispute settlement system – the most ambitious accomplishment of the Uruguay Round – nearly leveled the playing field for smaller countries. The alternatives will almost certainly leave them in a worse position.

In the face of such trends, what are the prospects for a renewed, and perhaps more stable, globalization? There are three key elements:

A Trade War Truce

Winston Churchill was famously quoted as saying that Americans can always be counted on to do the right thing, after exhausting all the other alternatives. And Trump's trade war seems to be approaching the point of exhaustion. After a flurry of threats and tariffs, the president appears to have lost his appetite for more, wary of negative market reaction as the 2020 presidential elections approach. And while the US economy remains strong, the sole winner from the whole effort has been the profits of US steel companies. Trump had hoped to use the tariffs to bludgeon allies into more favorable trade deals, but the only victories to date have been modest renegotiations of the trade agreements with Canada, Mexico and South Korea.

China poses the most difficult challenge. The tariffs against China are far more popular in the US than those on allies. But even here, there is little confidence that that US sanctions and bilateral pressure alone will produce big changes in Chinese economic practices. The Trump administration appears to be waking up to the reality that the US and China will face years, perhaps decades, in which economic cooperation and economic conflict will be inter-mixed. In such a long struggle, the US will need all the allies it can get.

Filling the Leadership Vacuum

Even if the US and China reach some kind of temporary truce, the absence of trade conflict will not by itself strengthen or reform the rules-based trading system. The two economic superpowers could instead begin to carve up the world into zones of influence, offering special favors for countries that cooperate and levying sanctions against those that don't. Countries like Japan and Australia – close US allies that depend especially heavily on the Chinese market – would find themselves in an unenviable position, tugged back and forth between their two most important partners.

There is growing recognition of this danger and attempts to bring the US and China back into the fold. The EU and Canada have led efforts to reform the WTO dispute settlement system, especially the Appellate Body that has been a target of US complaints. The US has supported efforts by the EU and Japan to launch new WTO negotiations focusing on e-commerce. The upcoming G20 summit in Osaka, with Japan in the presidency, is an opportunity to discuss bolder proposals. These should include work on curbing distortive industrial subsidies, guidelines for limiting currency manipulation, and efforts to curb harmful tax competition that has allowed many multinational companies to avoid taxes and erode the revenue base that governments need to tackle the challenges of globalization and automation.

It is far from clear whether the G20 has enough coherence, or sense of common interest, to step up to this role. It came closest in the early months of the 2008 financial crisis. But such a coordinated leadership effort is desperately needed. The last time the global economic system faced similar uncertainty over the rules was in the early 1970s following Nixon's decision to pull out of the fixed currency regime established by Bretton-Woods. At that time, negotiations and coordinated efforts by the major economic powers – including Japan, Germany, France, and the UK – were critical to re-establishing confidence in the international financial and trade systems. A similar effort is needed again. China and the US will be reluctant participants at best, but may become weary of their bilateral struggles and willing to consider other paths forward.

Meeting the Challenges at Home

No reconfiguration of the international rules will matter in the absence of domestic policies that start to tackle rising inequality. In the US, this is the issue that will be at the heart of the 2020 presidential election, with Democrats calling for an array of measures including a higher minimum wage, cheaper or free college education, health care for all, and increased taxes on the wealthy. The disruptions caused by global economic competition are only likely to accelerate with the advance of automation and artificial intelligence; McKinsey & Co. predicts that as many as one-third of workers could need to change occupations or acquire significant new skills over the next decade as machines replace tasks long done by humans. If governments cannot do a better job of helping their citizens manage this transition, discontent with the economic rules – including global economic rules – will continue to grow.

The post-World War II economic order, which has done so much to spread prosperity across the world, is in the midst of the largest challenge it has yet faced. It will require courage and creativity to find a better path forward. JS

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