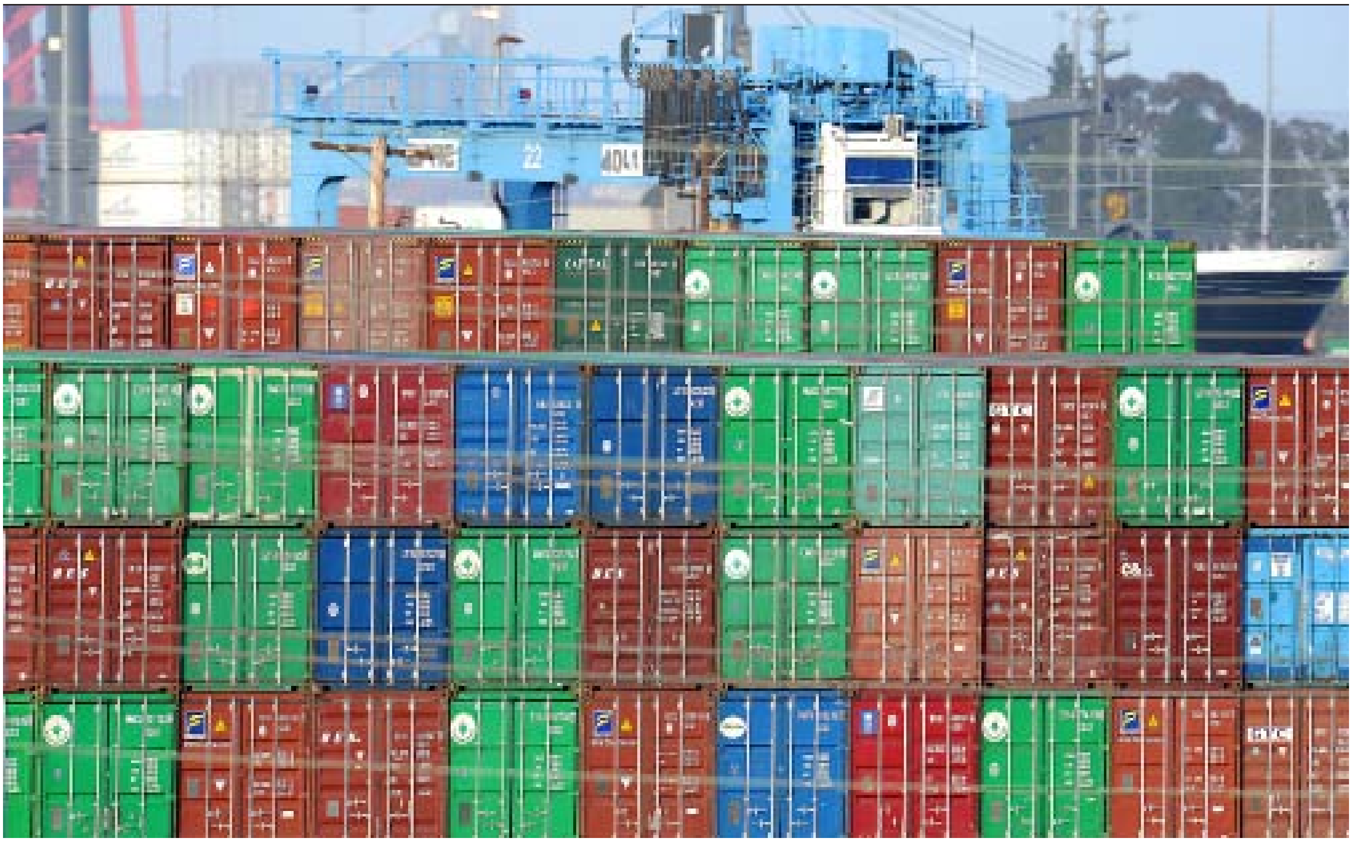
The Globe



PHOTOGRAPHY: GETTY IMAGES

Shattering the Myths About U.S. Trade Policy

Forget the doomsayers, and stop blaming trade. An active trade policy can lead to a stronger U.S. economy. *by Robert Z. Lawrence and Lawrence Edwards*

ABOVE A ship passes behind a stack of containers at the Port of Los Angeles, in May 2010.

"As they say on my own Cape Cod, a rising tide lifts all the boats," declared U.S. President John F. Kennedy several times during the 1960s. That picturesque metaphor encapsulates the assumptions underlying America's trade policy since the Marshall Plan in 1948, and it has served as the linchpin of U.S. competitiveness strategy ever since.

Kennedy had it right: A free and fair global trading system can result in economic win-wins. Open borders allow companies to grow in foreign markets and, simultaneously, ensure that businesses remain competitive at home. That's why U.S. policy makers have traditionally urged developing countries to reduce tariff and nontariff barriers, often arousing their ire. Few could dispute that logic when, from 1980 to 2000, the world's biggest economy grew just as rapidly as that of all other nations on average.

However, the skeptics about free trade have been gaining influence over the past decade. The longest post-War expansion in America, from 1991 to 2000, ended when the dot-com bust led to a recession in which the U.S. manufacturing sector shed almost 3 million jobs. A sluggish economy (GDP growth averaged 2.3% from 2000 to 2007) and the rapid development of emerging markets shrank America's share of global GDP by about 10%. The United States experienced large trade deficits and rapid increases in imports from developing countries, particularly China.

CROSS REFERENCE reference the Porter Overview

Not surprisingly, many Americans blame free trade for their nation's slide. The *Wall Street Journal* reported that although 24% of Americans earning over $75,000 a year had supported new trade agreements in 1999, over 50% believed by 2010 that such deals were hurting the United States. The growth in the offshoring of business services over the internet added to the tension. If developing countries' growth is hurting the U.S., the logic went, that would justify the use of a protectionist trade policy that would preserve American incomes by keeping the rest of the world poor.

The rising opposition to America's trade policy has two dimensions. The first pertains to jobs. In a 2008 poll, only 30% of respondents indicated that the statement "international trade is good for the U.S. because it leads to lower prices for consumers" came closest to their views; 63% agreed that "international trade is bad for the U.S. because it results in the loss of jobs and lower wages."

Second, some economists argue that trade is damaging America's welfare, with global competition hurting U.S. exporters, reducing wages, and increasing wage differentials. That's vexing, because those experts suggest that the effects are not temporary and will persist even if the U.S. economy grows quickly and returns to full employment.

Emblematic of this view was an article, written in April 2008, by former U.S. Treasury Secretary Lawrence Summers, who invoked the authority of economist Paul Samuelson to argue that developing countries' growth wouldn't necessarily improve welfare in the U.S. Summers wasn't the only one to sound the alarm: Hillary Clinton, during her 2008 presidential campaign, used Samuelson's theory to support her position that the U.S. should call a time-out on negotiating free-trade agreements.

Summers also noted that in addition to greater competition in export markets, the growth of developing countries like China would increase oil prices, raising America's energy-import bill. In addition, he observed that although global growth might benefit Americans whose intellectual creations earn rich rewards (filmmakers, for example), such growth could exert downward pressure on U.S. wages in high-tech industries such as computer manufacturing. Like Summers, Nobel Prize–winning economist Paul Krugman argued in 2007 that rising trade with developing countries could reduce the real wages of most U.S. workers and increase income inequality.

Just how valid are these concerns? To find out, we conducted a series of in-depth analyses of U.S. trade data by using regression analysis, other statistical techniques, and input-output analysis. Our findings contradict several popular theories about the impact of U.S. trade with developing countries and demonstrate that trade has been assigned a villainous role that far exceeds its actual impact on America's economic difficulties.

To be sure, some imports have caused harm, as trade-related job losses hurt specific communities and prove to be costly for displaced workers. However, trade actually accounts for only a small part of America's economic problems, and many myths surround its role in causing them.

MYTH 1

America's trade policy is the main cause of job losses, especially in manufacturing. Manufacturing's contribution to employment in the U.S. has fallen steadily for over half a century, long before America started running trade deficits. The rate of decline from 2000 to 2010—about 0.4 percentage points a year—was the same per year as during the previous 40 years. Moreover, the United States isn't unique: Data going back to 1973 show that all industrial countries, even those with large trade surpluses such as Germany and the Netherlands, have reported a similar trend. (See the exhibit "Manufacturing Employment Has Fallen Steadily and Globally.") Many people blame trade for the decline in America's employment in manufacturing, but our research shows that the long-run drivers of the trend in the U.S. are primarily a combination of two other factors: increasing productivity growth in American manufacturing, and a shift in demand away from goods toward services.

America's deindustrialization is "made in America," so to speak, and it results primarily from Americans' spending decisions. While productivity growth has led to lower prices, demand has not grown sufficiently rapidly to prevent a declining trend in employment, the data suggest. The reason is similar to that which reduced employment in agriculture: Faster productivity growth has allowed the U.S. to meet its needs for goods and to redeploy workers to other parts of the economy.

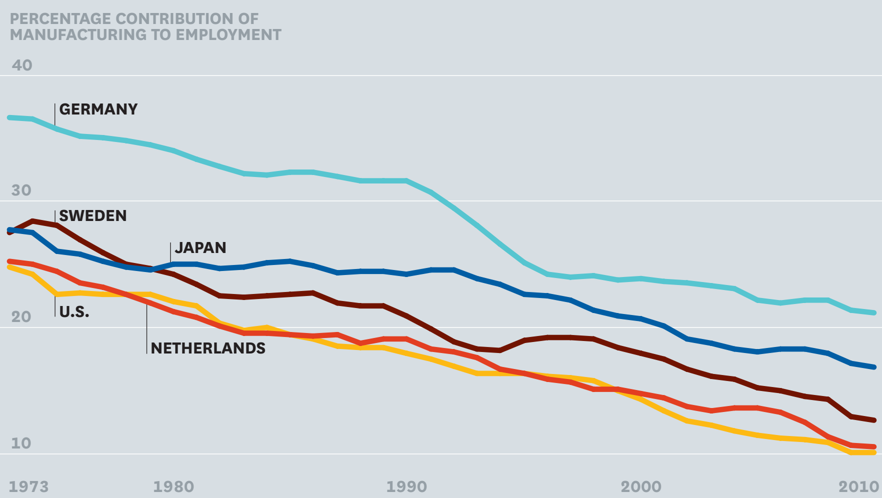
Trade deficits in manufactures have played only a partial role in reducing employment—and almost no role over the past decade. Using input-output tables that list the job content of production, we found that in 1998 and 2010, replacing imports with domestically produced goods would have increased manufacturing employment by 2.6 million and 2.9 million in each of those years, respectively. Over that decade, however, the fall in manufacturing employment, to the tune of 6 million jobs, would have been the same with balanced trade as it was with the deficits that the United States actually experienced. (See the exhibit "Balanced Trade Won't Offset Job Losses Permanently.")

The main cause, again, is the increasing growth in labor productivity. In current dollars, the manufacturing trade deficit

Trade with developing countries has been assigned a villainous role that far exceeds its actual impact on America's economic difficulties.

Manufacturing Employment Has Fallen Steadily and Globally

In the U.S., manufacturing's share of employment fell by about 0.4 percentage points a year from 2000 to 2010—almost the same as during the previous 40 years. The U.S. isn't unique: All industrialized countries, even those with trade surpluses such as Germany and the Netherlands, have reported a similar trend.



SOURCE U.S. BUREAU OF LABOR STATISTICS

was twice as large in 2010 as it was in 1998, but the output per worker was higher, so the job content of each dollar of deficit has been falling rapidly. Even if the U.S. had enjoyed balanced trade in the past two decades, the share of manufacturing in employment would still have tumbled.

Free-trade critics claim that imports have been an important contributor to unemployment, especially during the recent recession. However, we found that the association between employment growth and import growth has been positive. When Americans spend more, they create more jobs at home and they buy more final products and inputs from abroad. In fact, trade has typically boosted employment during downturns because U.S. recessions have usually started at home—not in its export markets—and Americans have cut back on imports faster than on their purchases of domestic products. Even in the years after free-trade agreements were signed, U.S. employment growth has been strong. This suggests that, whatever their net effect on employment, these pacts have affected aggregate unemployment in only a modest way.

Undoubtedly, imports have caused some disruption, including job losses and worker dislocation, and it would be wrong to minimize their importance for the affected people. However, trade is only one of the many reasons why U.S. companies lay off workers.

For a long time, Americans have favored the purchase of services over goods. After a spurt in the 1990s, even the share of spending on high-tech products such as computers and peripherals declined despite a relative drop in prices for those goods. Under current circumstances, reducing the trade deficit by increasing exports can boost manufacturing employment. However, any respite is likely to be temporary, and the falling trend in the share of employment in manufacturing will resume sooner or later.

MYTH 2

U.S. living standards are falling and wage inequality is rising because developing countries compete with the U.S. in its export markets on cost. The claim that trade with developing countries has reduced Americans' living standards is questionable. Although trade has resulted in lower wages for some workers and occupations over the past decade, studies of recent data don't show that it created economywide increases in inequality. The reasons why trade has improved welfare and why it hasn't increased inequality are the same: The U.S. and developing countries have specialized in very different products and processes, making the latter complementary to America's growth.

The models used by Samuelson and Krugman to predict welfare losses and wage inequality are elegant but simplistic, as they assume that products, factors, and industries are homogeneous; that factors of production are mobile within countries; and that the U.S. and developing countries make similar products. In reality, most products differ in terms of price and quality, factors of production are often used for specific tasks, and many products exported by developing countries are no longer produced in the U.S. That also explains why the economy-wide pressures of trade on wage inequality in America are muted. When the U.S. no longer makes certain products, the declining prices of imports benefit all consumers and do not affect relative wages.

Consequently, distinctive patterns of international specialization have emerged. Developed and developing countries export fundamentally different products, especially those classified as high-tech. Even when exports from both types of countries are in the same product category, prices differ greatly, suggesting that the products made by developed and developing nations are not substitutes for each other.

Higher-tech products have greater scope for product differentiation, enabling U.S. producers to better insulate themselves from foreign competition. Furthermore, the price and quality of developing countries' exports are, on average, low, while the average price gap between developing countries' exports and those of the U.S. hasn't narrowed. These findings shed light on the perplexing trend, exemplified by computers and electronics, that U.S.-manufactured imports from developing countries are concentrated in industries that employ relatively high numbers of skilled American workers.

Balanced Trade Won't Offset Job Losses Permanently

Closing the trade deficit in manufacturing would give a one-time boost to manufacturing jobs, but it wouldn't permanently offset the decline in manufacturing's share of employment. An input-output analysis indicates that without a trade deficit, there would have been more manufacturing jobs in both 1998 (by 2.6 million) and 2010 (by 2.9 million). But that would not have altered the decline in manufacturing employment over that period.

SOURCE BUREAU OF ECONOMIC ANALYSIS

Specialization also explains why America's non-oil terms of trade—defined as the ratio of export to import prices—have improved. The gains from America's trade depend on that ratio. Samuelson pointed out that if productivity growth abroad occurs in industries that compete with America's exports, the U.S. could lose out, as the prices of its exports would fall relative to those of its imports. But that hasn't happened.

The reason is simple. As economist John Hicks theorized, countries in the early stages of development are most likely to experience rapid productivity growth in the industries in which they have a comparative advantage. Such export-biased growth will actually improve the terms of trade of their more developed trading partners. When we explored the U.S. terms of trade, we found ample support for Hicks's theory: From 1993 to 2010, the manufacturing terms of trade improved primarily because the relative prices of U.S.-manufactured imports from developing countries declined.

Even accounting for the impact of larger deficits on the terms of trade, the growth of developing countries has benefited the U.S., according to our estimates. In fact, a regression analysis indicates that had the developing countries grown faster, the variety of imports available to Americans would have been greater and the terms of trade would have been better for the United States.

MYTH 3

The rapid growth of emerging markets like China and India is the most important source of higher oil prices that hurt Americans. Because the United States imports about 58% of its oil, the price of oil heavily influences the nation's trade benefits. Oil is undoubtedly an exception to the favorable impact that the growth of developing countries has had on the U.S. terms of trade. After all, oil importers from developed and developing countries compete directly.

However, major misperceptions exist about the impact of countries such as India and China on oil prices. The primary responsibility for the shortfall between demand and supply that has caused oil prices to soar in recent times rests with developed countries. Consider, for instance, the relative contributions of supply and demand from 2000 to 2008, when oil prices rose to $95 a barrel, on average. Many attribute those high prices to the growth of demand in emerging markets, but our models show that slow production growth in developed countries was a more determinative factor.

From 2000 to 2008 oil production by the countries of the Organisation for Economic Co-operation and Development, which account for 30% of world production, declined by 9%, or 2.3 million barrels a day. In combination with these countries' growing demand, which rose by 3.1 million barrels a day, this created a shortfall that explains as much as 81% of the price rise over the period.

Sure, the increase in net Chinese demand, by 3 million barrels a day, was responsible for 34% of the price rise, but greater supply in other developing countries offset that by 15 percentage points, so overall the developing countries accounted for 19% of the rise—far lower than many think. In fact, the impact of the net-supply shortfall created by the U.S., where production fell by 6%, was quite similar to that created by China's demand increase.

Strong growth in emerging economies may not necessarily lead to higher oil prices in the future. U.S. Energy Information Administration scenarios suggest that increased global supply (or reduced demand) of just 1% a year would reduce oil prices in 2030 by 75%, compared with what they would otherwise be. Therefore, relatively small changes in the production and conservation of liquid fuels may make it possible to accommodate demand from emerging economies without a major increase in oil prices.

A Trade Policy for Tomorrow

Paralyzed by these myths, America has attained only modest accomplishments in trade policy since 2007. This is unfortunate, as an active trade policy could enhance Americans' living standards and facilitate a return to growth.

As Americans learn to spend less, more of the demand for their output has to come through trade. President Barack Obama recognized this when, in his 2010 State of the Union address, he set the goal of doubling exports in five years. Exports can be boosted by a weaker dollar or by greater investments that make goods and services cheaper, more attractive, or more prominent. But both strategies are costly: A weaker dollar raises the cost of buying foreign products, while innovation, investment, and trade promotion require additional resources. However, policies that open foreign markets can boost the demand for U.S. products without additional outlays by Americans. Because trade barriers are much higher overseas than in the United States, free-trade agreements do just that.

The U.S. also needs to be more active in sustaining a trading order that supports its economic interests. This is a challenge as large emerging economies like China become more influential. The Chinese market is fairly open with respect to tariffs. But to promote its development, China has an array of measures, designed to encourage domestic innovation and production, that are increasing friction with its trading partners.

However, China needs open markets for exports, abundant supplies of raw materials that it doesn't produce, and opportunities for its companies to invest abroad. The U.S. should leverage China's need for international economic engagement to secure its cooperation in the WTO and its adoption of a more open domestic market. America ought to do this both bilaterally and in coordination with other countries that have similar complaints about China.

In 2001 the United States supported China's accession to the WTO, but only after China agreed to open its markets. The U.S. needs to build on that success. China should be at the forefront of the talks to liberalize services, for instance. In return for Chinese concessions, the U.S. should grant China recognition as a market economy, with normal remedies in antidumping and safeguard cases, and end the annual compliance review of China's trade policy.

America has traditionally provided leadership in multilateral trade negotiations, but the current Doha Round of talks is moribund, and U.S. leadership is conspicuously absent. The European Union, Japan, China, and India are all signing bilateral deals and participating in multinational regional initiatives. The U.S. was active in negotiating bilateral agreements, but the three concluded by the Bush Administration by mid-2007 were ratified only in late 2011.

> The United States needs to help end the Doha Round of talks and to reconstruct the WTO once the talks end.

A revitalized U.S. trade policy should also help end the Doha Round. The WTO's largest members, such as the U.S., China, and the EU, should put additional offers on the table and exercise the leadership required to reach a meaningful agreement. The U.S. also needs to help reconstruct the WTO once the Doha talks end. It should do that by striking new plurilateral agreements with members on issues such as foreign investments and competition policy.

The U.S. must be more active at the WTO, both in bringing cases to enforce its rights under existing agreements and in negotiating for new rules that improve market access. From 2008 to 2011 it launched just seven complaints at the WTO—equal to the annual average of complaints it brought from 1995 through 2008. While the U.S., the EU, Mexico, and other countries have jointly brought a few cases, their efforts should be more coordinated in the future.

TRADE POLICIES are an important complement to other measures that can enhance U.S. competitiveness. Inventing new products is of little use if other nations 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 will be hindered if American corporations do not enjoy the access to foreign markets that companies based in other countries have.

An alternative strategy could be to raise trade barriers in an effort to generate more demand for U.S. production. However, erecting higher barriers 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 doing so could prompt retaliatory responses that endanger the fragile world economic recovery and make everyone worse off. Freer trade, not protectionism, may be a better option.

HBR Reprint R1203Q

Robert Z. Lawrence is the Albert L. Williams Professor of International Trade and Investment at the Harvard Kennedy School, a senior fellow at the Peterson Institute for International Economics, and a research associate at the National Bureau of Economic Research. **Lawrence Edwards** is an associate professor in the School of Economics at the University of Cape Town. They are the authors of *Rising Tide: Is Growth in Emerging Economies Good for the United States?* (forthcoming from the Peterson Institute), for which much of the research described in this article was conducted.