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False Expectations of Trade Agreements: Lessons for Change

I've negotiated numerous trade agreements during my 30 plus years of government service, and in that time have witnessed a continuing decline in support for the pacts. We all remember when opposition reached its height during the 1999 WTO Ministerial in Seattle, when public demonstrations halted any significant negotiations or progress toward a commitment for a new round of talks. While those demonstrations have not been repeated, the negative sentiments still prevail. What accounts for this opposition? Is it simply a lack of public understanding, as the corporate sector would like us to believe?

The truth is, many segments of America have not shared in the benefits of trade. Real family income levels remained stable or declined for most of the population during the last eight years with families at the lower end suffering the most. At the same time, prices of fuel, food and health care cut deeply into family budgets. Conversely, high income families saw significant increases in real income as did corporations that had profits double.

Even among corporations, the distribution of wealth was uneven with multinational companies benefiting far more than businesses focused on the U.S. marketplace. In short, we have become a nation bent on increased profits for the few and increasing poverty for many.

My reflections have led me to the conclusion that trade agreements have simply failed to live up to their expectations. We have become a nation driven by conventional wisdom of free trade and comparative advantage. A few voices have questioned the wisdom of convention. The Nobel Committee awarded its economic prize to Paul Krugman, who explained why commerce occurs among similar economies trading similar goods. Paul Craig Roberts, a former assistant secretary of the Treasury during President Reagan's term, has questioned the applicability of comparative advantage. But, for the most part, we have become captive of these labels, preventing us from accurately assessing whether trade agreements actually deliver what they promise.

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* The opinions in this presentation do not necessarily reflect the views of Kelley Drye & Warren LLP.

I make these statements in the interests of transparency so that you understand that I speak from a Liberal, Progressive perspective. Having spent so many years in government service working for Republican and Democratic Administrations, I tried to play a neutral role doing what public servants do best, helping each duly elected government achieve its objectives. Like so many of my colleagues, we worked diligently and sincerely many times in spite of our own personal perspectives. And, as a result, I have nothing but enormous respect for the dedication of the civil service of which I was so long and proudly a part.

The China Example

China is the perfect example of failed expectations, and I use it not because I was instrumental in China's accession to the WTO, but because of its economic size and because that agreement is the most extreme case where benefits should have flowed mostly to the United States and other countries. China's accession to the WTO required China to make unilateral concessions on nearly all its tariffs and to unilaterally eliminate its non-tariff measures. Other countries, for the most part, made no concessions to China other than providing permanent Most-Favored-Nations treatment, or what we now call Normal Trade Relations.

While no one claimed that China's accession to the WTO would eliminate the growing bilateral trade deficit, claims were made that U.S. exports of goods to China would increase substantially, thus creating jobs in the higher-paying export sector.

Six years later, U.S. exports to China have increased and, as the U.S. Trade Representative (USTR) often emphasizes, have increased at a higher rate than U.S. exports to any other country. But such claims distort the real truth -- that exports to China 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 U.S. exports of goods to China. The increase in absolute terms was 40% more to Canada 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 only $82 billion and imports from the EU increased by only $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 in 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 2.7 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, as I mentioned earlier, has been stable or declining for most households.

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. Trade is driven by monetary and fiscal policies as well as competition policies around the world.

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 and exports, 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 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. Even in this crisis period, China's exports to the world have declined but its imports have declined even further, resulting in an increased surplus and increased foreign exchange reserves.

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 limited 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 also 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.

Lessons for Change

President Obama declared in his inaugural address that we need to end the false promises and worn out dogmas that have strangled our politics. We cannot exempt the trade policy from this housecleaning. We need to carefully assess what has worked and what has not, putting aside our own complicity in those policies and agreements. We need to incorporate new ways of addressing issues of competition and competitiveness. We need to ensure that the benefits of trade extend beyond the corporate sector and their mega-salaries.

Based on the experiences of the past, I would offer five overarching lessons that should guide decisions of U.S. trade policy. Are they the only ones? No. But they are ones that I think the Administration will have to address in any overhaul of U.S. trade policy.

1. Base Trade Policy on U.S. economic self interest

First, Trade Policy should be based on U.S. economic self interest. One would think that this principle is self-evident but it is not. Ambassador Robert Zoellick declared eight years ago that trade policy was a subset of Foreign Policy. As a result, USTR embarked on a policy of competitive liberalization involving Free Trade Agreements with a number of smaller economies largely for foreign policy reasons. The FTA with Korea for example is part of a broader strategy of surrounding China with bilateral FTAs. The underlying premise has been that "Free Trade" is always good and that foreign policy issues always prevail. For the most part, these "Free Trade Agreements" have been preferential market access agreements that do little to expand U.S. trade but offer enormous benefits to those small trading partners that want increased access to the U.S. marketplace.

U.S. economic self interest is not the same as corporate self interest. For decades, U.S. policy has treated them as equivalent. There is not enough time to list the number of cases where corporations have sought tariff and non-tariff concessions that would benefit their exports from other countries. There are also cases where corporations requested that we not seek concessions because they wanted a protected market for their newly established manufacturing and sales operations.

U.S. economic self interest means that government action is pro-active. The last Administration preferred to engage in dialogue in order to avoid trade conflicts. Few trade complaints were brought to the WTO for fear of disrupting the "relationship" or endangering U.S. investment interests abroad and, of those few, overwhelming evidence was required. However, without the willingness and the commitment to use trade enforcement, dialogue becomes a weak instrument. Practicality will have to dictate the appropriate role for Foreign Policy in the trade policy framework but economic self interest should be the final arbiter.

2. Trade Policy has only a limited reach

Second, Trade Policy has only limited reach in rebalancing the benefits of trade expansions to broader segments of the economy such as labor. Simply put, the major problems facing trade are not deficiencies of Trade Policy but of monetary, fiscal and competition policies. As Treasury sets the economy on a more stable footing, exchange rates need to be set by markets, not by political fiat. The past Administration paid lip service in addressing the most serious financial issue of currency undervaluation. The Administration used the IMF to seek greater surveillance of exchange rates. However, that effort was doomed from the start because so many parts of Asia maintain undervalued currencies to stay competitive with China. Without adequate disciplines over the use of exchange rates for commercial purpose, the long-term sustainability of the U.S. economy as well as the global remains questionable.

Nevertheless, trade policy can play a constructive, although more limited, role in achieving meaningful discipline of manipulated exchange rates. Unilateral use of countervailing duty laws and anti-dumping laws to address unfair competition resulting from manipulated exchange rates would be an effective tool to bring greater discipline over the predatory use of exchange rates for commercial purposes and might even help bring countries to the negotiating table in the IMF.

In addition, the United States should consider taking China to the WTO on its manipulated exchange rate. The only country capable to standing up to China is the United States; other countries will not take the lead. Other countries will support such action, but U.S. leadership is essential for success. A coalition of the willing could include the EU, Australia, Canada, New Zealand and the Nordic Countries. Even Switzerland might want to play a constructive role.

3. Broaden the decision-making and advisory system in U.S. Trade Policy

Third, the decision-making and advisory processes of Trade Policy need to be better balanced. On a practical level, labor and environmental concerns are not included in trade policy debates, or when they are included, are often ignored. In the various policy debates that have been conducted in the past, rarely was Labor ever included in those deliberations. The major players were State, Treasury and Commerce with Agriculture occasionally included when Agricultural issues were involved. We need a more robust debate on trade within the Administration and Labor and environmental interests need to be incorporated in every aspect of trade policy. A first step would be to include labor and environmental interests in each advisory group, including the sector groups.

Furthermore, we need to examine how the United States and other countries can remedy unfair competition from countries that have low or no labor standards and countries that do not provide environmental protection. We need to abandon the race towards the bottom on labor standards and the undermining of global warming by countries without environmental standards. I feel confident that such legislation to allow trade cases based on unfair advantages on labor and environmental standards could be enacted that would be fully consistent with WTO principles. And both can be achieved without unduly burdening corporations that fully comply with U.S. labor and environmental laws whether they manufacture at home or abroad.

4. We need to get our trade relationship with China on a balanced footing

Fourth, we need to get our trade relationship with China on a more balanced footing. Past administrations, and I use the plural purposely, have put a heavy emphasis on dialogue. Dialogue has had some significant successes; USTR Charlene Barshefsky, by shear will, was able to wrestle the enormous 1999 market access agreement despite overwhelming obstacles. But over the last eight years, dialogue has been elevated to the highest levels of the Cabinet and yet it has achieved very little. "Where's the beef," is both a literal and figurative expression that applies to China. The only meaningful result has been the lack of conflict, an objective for which China and those companies that moved their plants to China are extremely indebted.

For two decades, the United States – largely for budgetary reasons – has focused on negotiation to resolve highly contentious issues with China. Those negotiations have tried to remedy the problems by getting China to take action within its own borders to resolve the dispute. How successful has that been? U.S. Imports of counterfeit products, including copyright and patent violations, from China exceed by large multiples those from any other nation. And they are increasing. Worse yet, this policy leaves to China to enforce its laws regarding health hazards such as melamine tainted goods that affect U.S. imports of pet food and baby food. Why are we relying on China to safeguard U.S. citizens? This is a case where we are willing to risk the health and safety of our population because of the fear of big government, for example, a larger customs force to inspect imports.

As I already mentioned, currency undervaluation is the principle destabilizing factor in our bilateral trade relationship, not only with China but with other Asian economies as well. It has created an interconnected relationship with the rest of Asia where China imports raw materials and unfinished goods to be further manufactured or assembled in China for export to the United States, Europe, Japan and other developed countries. In short, the Chinese economy has become the classic example of export-led growth upon which the rest of Asia depends. This is a fragile relationship in the current economic environment. China, as the third largest economy in the world, needs to play a more active role as a destination for other countries' exports. China needs to open China to China and open China to the rest of the world. Appreciating its currency will go a long way in turning the focus of the economy around. But China needs to use its foreign exchange reserves to expand it economy and it needs to stop the multitude of measures that restrict access to the third largest economy in the world.

Trade policy can play a constructive role by being more assertive on trade disputes. The U.S. failure to use the product specific safeguard provision of China's accession agreement has left struggling U.S. companies unable to compete against China's unfair trade practices. Similarly, more aggressive use of domestic trade laws may be necessary to defend the interests of U.S. companies and their workers while China takes the steps necessary to transform its economy to a more balanced structure of internal and export led growth. In this regard, during the last eight years, the last Administration never accepted any 301 petition and even turned down one petition before it was filed. This failure has created a system of dispute resolution that is highly non-transparent. We need to return to a system where trade disputes are open to public scrutiny, and accountability.

5. Reconsider Trade Promotion Authority

Trade Promotion Authority (TPA) has been the hallmark of multilateral trade negotiations and, like the mantra of Free Trade, it is conventional wisdom that trade negotiations cannot take place without such authority. I believe that such authority is unnecessary and, in fact, detrimental. Its protectors argue that TPA is necessary to prevent Congress from renegotiating the agreement. This statute may have been desirable when tariffs were high, but tariffs are low or nonexistent now and Congress should focus on what concessions other countries have given, not U.S. concessions. Congress has, in fact, little scope for renegotiations, only approval or disapproval of domestic legislation to implement those agreements.

TPA allows U.S. trade officials to be lax in the negotiations. In the Uruguay Round, for example, few real tariff concessions were gained from Latin America and for large parts of Asia. WTO Agreements on standards, for example, essentially allow countries to use standards as barriers to trade but provide little basis for action. Increasingly standards barriers are becoming the biggest obstacles to increased exports to China by denying access for agricultural and manufactured products into the Chinese marketplace. In addition, I would remind everyone that China negotiated its accession to the WTO without such authority. I can't begin to tell you how many times Ambassador Barshefsky said to me, "We need to do better," on the China Market Access Agreement where we didn't have trade promotion authority.

Foreign countries argue that they do not want to negotiate twice, once with the Administration and then again with the Congress. As a practical matter, Congress has frequently extracted new commitments for other government even after negotiations have been concluded, in order to ensure passage. Most other countries do not have similar mechanisms and, speaking from personal experience, some have failed to implement the provisions that we negotiated in the GATT/WTO.

Most important, for the United States, the remaining trade concessions that are available in trade negotiations are the most difficult to make. Conversely, in multilateral negotiations, developing countries have rarely provided meaningful market access under the WTO. Any agreement that resolves those nettlesome issues must ensure that trade benefits flow to the broader U.S. economy if passage through the Congress is to be successful.

We need to develop support for trade liberalization that existed when I first entered government. It will require far more transparency than has existed over the last eight years where advice was sought only from carefully selected advisory groups. It will require a more robust dialogue with all sectors of the economy, not simply the corporate sector. But, in seeking broad engagement on trade policy, it should not be at the expense of corporate interests. The dialogue must be inclusive so that support for trade liberalization will exist in the Congress without the need for extraordinary legislative authority.

Conclusion

There are important reasons why we need to assess and overhaul U.S. trade policy immediately. Long term stable growth of the economy will require that the export sector outperforms the rest of the economy. Our current account deficit, our government budget deficit and the huge disparities in foreign exchange reserves all dictate that exports must lead the way for stable long-term economic growth. And as the nation invests in energy technologies and environmental technologies especially those centering on global warming, we will have newer and growing export industries. In short, long-term economic stability, without the bubbles of the last two decades, will require the United States to dramatically improve our trade and current accounts.

And finally, if history is prologue, we should expect that once the recovery appears to be on a more solid footing, foreign leaders, corporate CEOs, and many think tanks will press the Administration to engage more fully in global trade negotiations. This Administration, like other administrations, will find it difficult to oppose such efforts. Thus the Administration has a short window of opportunity to review U.S. trade policy and implement mechanisms and standards that will ensure the benefits of trade agreements flow to the broader U.S. economy and in ways that help achieve other goals such as improved labor standards and environmental objectives.