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Chapter 1

Protectionist Myths*

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Introductory Remarks

Pernicious myths about trade and protection permeate public discourse. In the US, they have been voiced by both Democrats and Republicans, from Bernie Sanders to Donald Trump, and repeated endlessly by even leading journalists.¹ But the repetition of false claims does not make them true. It is interesting that during the last Presidential campaign, Senator Sanders portrayed Scandinavian countries as examples of equality and social justice, saying that “in those countries, by and large, government works for ordinary people in the middle class, rather than, as is the case right now in our country, for the billionaire class.” But Scandinavian governments love free trade. In Sweden, even trade unions are against protectionism, as reflected in their support of the transatlantic trade and investment partnership (T-TIP)

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¹It is sad indeed that journalism schools in the US seem to teach you how to write but not what to write: their ignorance of the economics of what they write about is generally abysmal. The problem has been acknowledged by many in the field, including the former Dean of Columbia’s journalism school, Nicholas Lemann, and Harvard’s Tom Patterson, who calls for more “knowledge-based journalism” (Patterson, 2013). By contrast, the English economic journalists such as Martin Wolf of *Financial Times* and Clive Cook, formerly Editor of *The Economist*, and top German journalists in *Die Welt* and *Die Zeit*, for example, are superbly trained, not just in their craft but also in the discipline of Economics.

and other free-trade agreements. In fact, popular opinion in Scandinavian countries is enthusiastically positive toward trade. A 2015 survey of 4,600 citizens in Nordic countries shows that 71% of the respondents are in support of free trade, with Denmark — Sanders’s pet country — displaying the strongest support. In fact, in reaction to the protectionist moves engaged by the Trump administration in the US recently, the Danish Foreign Minister Anders Samuelsen said in an interview in April 2018, “We want to move in the opposite direction to the US and create more positive examples of what free trade can do.”

Notwithstanding protectionist propaganda, overall positive attitudes toward trade are shared all over the world. For instance, the Pew Research Center 2018 Global Attitudes Survey finds that 74% of Americans believe “trade is good” for the US, and the Eurobarometer survey — the most scientific polling of European public opinion — in 2017, asked the citizens of the European Union, “Could you please tell me whether the term ‘Free Trade’ brings to mind something very positive, fairly positive, fairly negative or very negative?” Nearly three quarters of respondents (73%) responded very positive or fairly positive. Globalization, which involves not just trade but also capital and labor flows, received a less positive rating, with about half of all respondents considering globalization to be positive.

The arguments made by protectionists are myths that can be successfully challenged. This chapter considers some of the most egregious ones.

Trade Openness Harms the Overall Economy

Much evidence opposes the protectionist view that opening markets to international trade causes harm to the economy. Most visibly, the post-World War II experience with progressive trade liberalization has coincided with remarkable prosperity, interrupted only by short periods reflecting macroeconomic shocks associated with (1) the success of OPEC and the consequent jump in oil prices during the 1970s, (2) the subsequent Volker-induced deflation of the world economy in the 1980s, and (3) the recent global financial crisis of the late 2000s. Indeed, per capita gross domestic product (GDP) — adjusted for inflation, in constant 2010 dollars — rose from \$3,694 to \$10,634 in the period of 1960–2017, an average of 3.3% a year.

This era of economic progress occurs in tandem with a sustained growth of trade, spurred by the liberalization occurring among developed countries under many rounds of multilateral trade negotiations (MTNs) under the auspices of the general agreement on tariffs and trade (GATT). Although developing countries were exempted from trade liberalization at the GATT under Part IV provisions for Special & Differential Treatment, they enjoyed improved most favored nation (MFN) access to developed country markets that were being opened up. So they

profited from liberalization by the developed countries. There has also been extensive unilateral and regional trade liberalization, in both high-income and developing countries, which reflects the general spread of the idea that protection is harmful.

The empirical evidence that trade liberalization is beneficial to the economy is now overwhelming. The very early studies on this issue suggested the gains from trade were positive, albeit small. Based on computations of the gains from trade in terms of utility, consumer and producer surplus, estimates were that the gains from trade were a few percentage points of GDP. Protectionists jumped on these results. They would argue that since the gains from trade were small, as its flipside, the costs of protection were negligible.² This means of course that, if protectionism is politically convenient, you need not shed tears over harming the country by surrendering to it. But while this theme will, and does, play in Washington, the mountain of research since those early studies supports the view that trade is much more beneficial to the economy.

First of all, the simpler methodologies adopted in the early studies have been supplanted by more sophisticated research methods. This involves considering the more comprehensive ways in which trade affects the economy. The University of California at Davis' Robert Feenstra (1992, 2018a) points out that the impact of protection on market structure was often ignored in earlier research. Protection from imports provides domestic firms with greater market power, which can ignite an increase in prices and magnify the deadweight losses for domestic consumers, evidence of which Feenstra provides in his research. At the same time, analysis of the trade liberalization episode in India in the early 1990s by Krishna and Mitra indicates significant pro-competitive effects of trade liberalization (Krishna and Mitra, 1998).

There is also the long-standing work of Harvard's Michael Porter on the effects that protection has on the competitiveness of firms. He has shown that increased competition from, and rivalry by, foreign firms forces domestic companies to increase their innovative efforts and become more productive (Porter, 1998). With protectionism, unproductive firms can survive under the umbrella of tariffs and non-tariff measures that subsidize their operations. Focusing on the effects of trade on different firms within an industry, Marc J. Melitz and Stephen J. Redding conclude that "[in a framework] in which trade induces a reorganization of production that raises domestic productivity, we show that the welfare gains from trade can become arbitrarily large" (Melitz and Redding, 2014, p. 317).

²Ironically, these claims of the miniscule costs of protection initiated from the research of the eminent and prolific University of Chicago economist Harry G. Johnson in 1965 (Johnson, 1965) who was an avid supporter of trade. He died at the untimely age of 53 in 1977.

And there is yet another reason why early studies of the effects of protection on trade produced small magnitudes. These models assumed the presence of a set of existing products, assessing the impact of trade and protection on those “old” goods. But as the recent Nobel laureate Paul M. Romer has said, “if international trade can bring new goods into an economy, the fraction of national income lost when a tariff is imposed can be much larger, as much as two times the tariff rate” (Romer, 1994, p. 5). The reason, as Romer shows, is that the gain in consumer surplus obtained from trade is not a marginal one associated with price reductions but the full surplus linked to having new products available locally that were not available in a protected economy. Empirical studies that have incorporated the benefits of increased product variety find substantial benefits from trade (see, for example, Broda and Weinstein, 2006). Estimates obtained by Ralph Ossa for a wide range of countries conclude that the median gain from trade in varieties across these countries is 55.9% of the GDP when compared with autarky (Ossa, 2015).

In conclusion, the evidence supporting the view that trade benefits — not harms — the economy is a slam dunk.

Free Trade May Increase Prosperity but it is Bad for the Working Class in Rich Countries

This myth has great credibility with the labor unions who believe that trade with the poor countries produces paupers in the rich countries. It has led unions to endorse trade openness between like-wage countries (e.g., CUSFTA between US and Canada) but to oppose it between high-wage and low-wage countries (e.g., extension of CUSFTA to include Mexico in NAFTA).

The anti-trade narrative charges that cheaper labor-intensive goods from the poor countries will harm workers in the labor-intensive industries of rich countries. In fact, this is what a simple application of trade theory suggests, according to the Stolper–Samuelson theorem (see Stolper and Samuelson, 1941). But for this to have any significance at all, the country must have a sizeable sector producing labor-intensive products and in the rich countries these industries have died out in various ways. In the United States, manufacturing employment has been declining since the 1950s, and so it has in other rich countries, such as Germany and Japan. This drop reflects a structural shift from industry to services, similar to the decline of agricultural employment that occurred earlier in the 20th century.

George Santayana — the Spanish–American philosopher — wrote the famous phrase, “those who cannot remember the past are condemned to repeat it.” It is interesting that just as imports are blamed today for the decline of manufacturing, so they were for the collapse of agricultural employment in the past. Let it be a reality check on the anti-trade activists: the precipitous drop of agricultural

employment in high-income economies happened despite the trillions of dollars of protection offered by the US government and other rich countries to their farmers over the years. This does not bode well for those who seek to reverse the declining trend in the economic status of blue-collar workers by imposing tariffs and other protectionist policies on manufacturing imports. It will not work and will be enormously costly to consumers and taxpayers.

Most economists have concluded that trade with poor countries is not the cause of the stagnation of rich-country wages. Instead, the principal culprit is homegrown: a downward trend of labor productivity growth. As any elementary school economics student understands, wages are closely aligned with productivity. And productivity growth has slowed-down big time in high-income countries. In the US, between 1948 and 1973, productivity growth averaged 3.3% per year, but this dropped to 1.6% between 1973 and 1995 and further to less than 1.3% since 2005. The only period when productivity did surge was between 1995 and 2005, when it averaged 3.2%, partly caused by the information and communications technology revolution. But this lasted for just a decade, after which productivity growth has come back down with a vengeance. Average productivity growth between 2011 and 2017 was about 0.4% per year.

With productivity increases slowing down, so has wage growth. What explains the collapse of productivity growth? The most popular view is that technological change and innovation — what economists call total factor productivity growth — has stagnated. Indeed “secular stagnation” is the buzzword among macroeconomists these days, although it was first coined by Alvin Hansen, who many call the American Keynes, back in the 1930s. Among the current technology pessimists is Robert Gordon, considered to be their superstar or, perhaps more correctly, their “dark horse”. He argues, in his 2016 book *The Rise and Fall of American Economic Growth*, that US innovation is faltering due to a lack of business dynamism, low investment rates, and a set of socioeconomic headwinds that are handcuffing the process of innovation, such as the slowdown of educational attainment and school quality, and the relative shift of the population to older age groups.

Other explanations for the American wage slowdown focus on the decline of unions and the drop of the real minimum wage (Levy and Temin, 2007; Blanchflower and Bryson, 2004). Others have emphasized that although wage growth has slowed down, the impact on total worker compensation has not been as severe, because the growth of benefits — such as healthcare — has exceeded wage growth (Lawrence, 2016).

Trade is definitely not one of the key factors slowing down wage growth in the US. If anything, trade has helped raise standards of living by counteracting the productivity growth slowdown, as all evidence suggests it has spurred greater productivity (see Melitz, 2003; Feenstra, 2018a). One could therefore argue that trade

helps not harms workers. Interestingly, the only time period when American productivity growth surged — between 1995 and 2005 — was also the heyday of trade liberalization, coming on the heels of the creation of the WTO in 1995, the implementation of NAFTA in 1994, and other trade liberalization moves.

Furthermore, it often goes unrecognized that — as consumers — workers benefit from the lower prices and greater variety of products harvested from imports, which raises their real wages. Using disaggregated price data for the United States during 1994–2005, University of Chicago economists Christian Broda and John Romalis have found that the “products that are consumed disproportionately by low-income consumers have been falling over this period. This fact implies that measured against the prices of products that poorer consumers actually buy, their ‘real’ incomes have been rising steadily” (Broda and Romalis, 2009, p. 21). They also strongly suggest that imports from developing countries, particularly China, account for the lower prices; indeed Bai and Stumpner (2019) conclude that between 2004 and 2015, Chinese imports may have reduced the prices of US tradable goods paid by consumers by 0.19 percentage points per year. Furthermore, Fajgelbaum and Khandelwal (2016) conclude that the poor gain the most from imported goods because they concentrate their spending in sectors that have more trade. One may not be surprised to see the same anti-trade Trump supporters avidly shopping for cheap Chinese-made products at Walmart or Big Lots!

Trade Openness Adversely Affects Poverty and Income Distribution in Developing Countries

This argument ignores the fact that there is little evidence that trade has caused increased poverty and income concentration. In fact, a bird’s eye view of the connection between trade and poverty in the developing world shows that trade is associated with *lower* not greater poverty. Consider the cases of China and India, the two economies that have seen some of the sharpest increases in openness. They are also the two countries that have experienced the strongest drop in poverty. Figures 1 and 2 show diagrammatically how increased trade — measured by the sum of the volume of exports and imports as a percentage of GDP — has been associated with a sharp drop of poverty rates in both countries, with poverty measured by the percentage of the country’s households living under the World Bank-based absolute poverty level of \$1.25 a day.

Furthermore, in contrast to China and India (and other East Asian countries where trade and export promotion have been used as development strategies), the region of the world that is more closed to trade, sub-Saharan Africa, is also the region that has struggled the most with poverty reduction (see Rivera-Batiz, 2013). Indeed, from 1990 to 2015, the World Bank estimates that poverty rates in

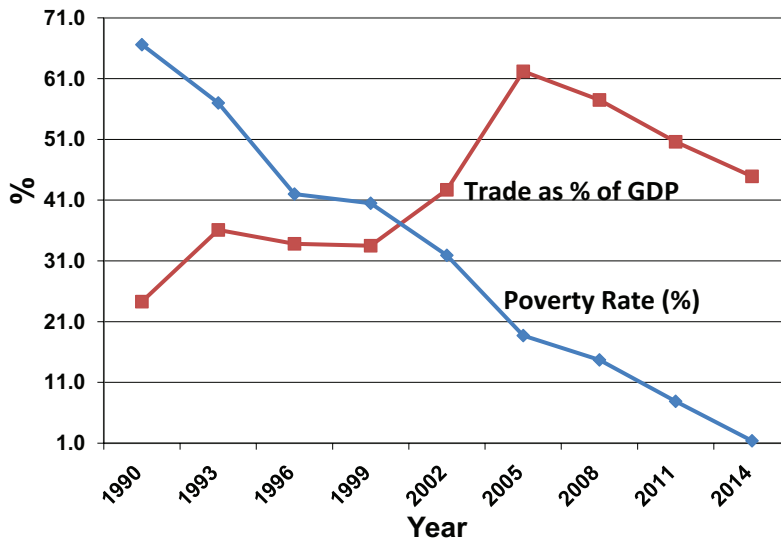


Figure 1. Trade as a percent of GDP versus poverty rate in China.

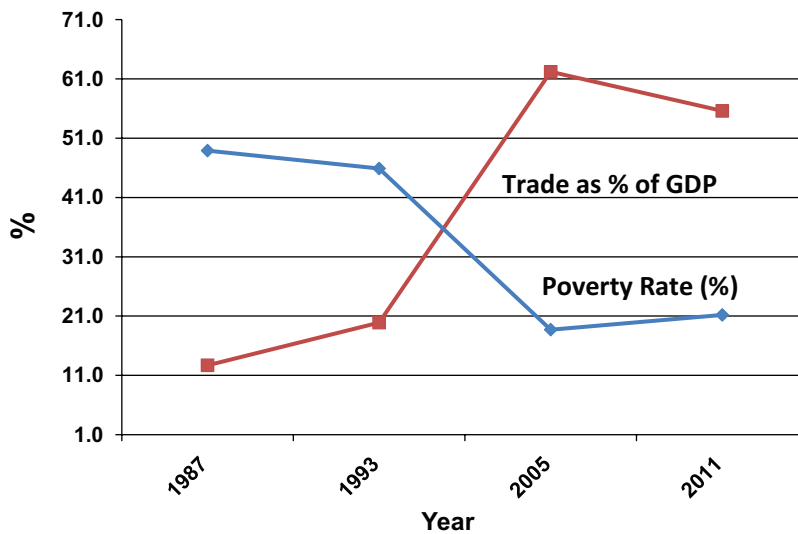


Figure 2. Trade as a percent of GDP versus poverty rate in India.

sub-Saharan Africa dropped only from 54.3% to 41.1%, compared to the drop from 61.6% to 2.3% in the East Asia and Pacific region.

These macro-statistics are confirmed by micro-studies that focus on how trade affects poverty within specific countries. For instance, in a detailed study of poverty levels in Indian states using household surveys, Devashish Mitra of the Maxwell School at Syracuse University finds that trade was not associated at all

with higher poverty rates. In the case of Mexico, which engaged in drastic elimination of trade barriers in the 1980s and early 1990s, Gordon Hanson at the University of California examined the impact of this liberalization. He separated regions of Mexico that had greater exposure to globalization and trade from those that had less exposure. He found that those Mexican states with high exposure to globalization had greater income growth and reduced poverty (Hanson, 2007). Similar results are found by Wei (2002) and Luo and Zhu (2008) for China, and Porto (2003) for Argentina. Indeed, in a collection of articles that examine the issue of how poverty and globalization are connected using case studies, Ann Harrison, the editor of the volume, concludes, "The evidence strongly suggests that export growth and incoming foreign investment have reduced poverty everywhere from Mexico to India to Poland" (Harrison, 2007).

If globalization has anything to do with poverty, critics of globalization may do well to focus on the increased level and volatility of financial capital flows as the more likely object of their anger. The financial crises that have been associated with this type of globalization have caused enormous pain to the poor, who are not only hurt by the economic collapses linked to the crises but also with the austerity programs they often lead to (see Bhagwati, 1998; Rivera-Batiz, 2001).

Let us turn to inequality. Critics of trade liberalization point out that in contrast to poverty, inequality has increased sharply in a number of countries over the last 30 years, a period that coincides with the growth of trade. But they ignore the fact that there have been a number of developing countries that have seen dropping inequality as well, such as Argentina, Brazil, Colombia, and Turkey, nations that have sharply reduced tariffs and other barriers to trade during the same time period.

Those who are concerned with inequality are barking at the wrong tree: there is no empirical evidence supporting the view that trade is one of the main factors behind rising inequality. For instance, in a study of income inequality in urban and rural areas of China, Shang-Jin Wei, at the Columbia Business School, finds no significant (or a small positive) relationship between changes in openness and changes in inequality in cities and a negative relationship between openness and inequality in rural counties, which means that increased trade has *reduced* inequality in rural areas of China. Similarly, Pravin Krishna and Guru Sethupathy find no association between trade and income inequality in India. They conclude, "The change in inequality across households within states is found to be uncorrelated with the changes in state-level measures of tariff and non-tariff protection."

The lack of evidence showing that trade has been the cause of greater inequality is shared by recent reviews of the literature. Elhanan Helpman at Harvard concludes, "globalization in the form of foreign trade and offshoring has not been a large contributor to rising inequality. Multiple studies of different events around

the world point to this conclusion” (Helpman, 2018, pp. 170–1710). The economist Martin Ravallion arrives at the same result as well: “trade openness does not seem to stand out as the major generalizable causative factor [of rising inequality] ... Globalization may well be getting too much credit, and being blamed for too much” (Ravallion, 2018).

Most economists point to skilled-biased technological progress — which has raised the demand for skilled workers relative to unskilled workers — as the main culprit for worsening inequality in both high-income and developing countries (see Berman *et al.*, 1998; Berman and Machin, 2000). The introduction of computers in the 1980s, the information and technology revolution in the 1990s, the automation and robotics innovations of the 2000s, and the current artificial intelligence breakthroughs have all altered the labor market in favor of more-educated, more skilled workers, reducing the demand for less-educated workers in routine, production tasks (Levy and Murnane, 2004, 2013). A recent paper by Burstein *et al.* (2019) confirms that most of the rising labor market inequality is due to technological changes, not trade, which accounts for just a few percentage points of the rising college wage premium.

Now, it is true that trade and foreign investment have helped the spread of the new technologies. And trade has certainly increased the income of the creators of the new inventions and the top officers of the companies that are based on them. But to cut off trade because of these outcomes is to kill the goose that lays the golden eggs. If you are really interested in combating inequality — in both high-income and low-income economies — perhaps you should pay more attention to progressive taxation and pro-poor transfer programs. This — not protectionism — should be the target of social progressives. It is the reason why in Denmark, by contrast to the US, inequality has not surged in recent decades even though Denmark engaged in pro-trade policies just as America did. Trade has very little to do with the difference in outcomes of the two countries, which is more connected to diverging social policies.

By the way, Thomas Piketty, who has documented the apparent increase in concentration of wealth and income over recent decades, ignores the fact that the top 1% is not made up of a static group. People move in and out of the group (i.e., there is inequality but also mobility). Many, from Oprah Winfrey to Forever 21’s Do Won Chang, would be disappointed that their rags to riches lives are part of a story that blames them for the rising inequality that permeates the world. It is also interesting that Piketty, who writes knowingly about English and French literature does not mention Thomas Mann who got the Nobel Prize for *Buddenbrooks* where the third generation’s fortunes decline. When we mentioned this omission to a French economist, he said amusingly that the French do not consider German literature to be literature!

Openness to Trade, Particularly with China, has led to the Shrinking of Manufactures in the US

The notion that trade openness has led to a decline of American manufacturing, by having factories shift to foreign countries with cheap labor or other natural and government-created artificial advantages in recent years, has also fed a near-frenzy of protectionist rhetoric.

But this belief is in error. The decline in manufacturing employment is a long-term phenomenon that has been ongoing for over a half century. This is evidenced by the steady — nearly linear — decline in the share of manufacturing workers in overall non-farm employment in the US since the 1950s, shown in Figure 3. It represents a structural shift in high-income economies from manufacturing to services similar to the shift from agriculture to manufacturing in earlier times.

That the decline of manufacturing in the US is a structural change among high-income countries and not the outcome of greater trade with China or other countries is supported by the undeniable fact that the decline has occurred for all of the industrial economies and long before the trade liberalization and globalization explosion that took off in the 1990s. It has happened even in Germany, universally considered a manufacturing export powerhouse. Germany has seen a drop in the share of manufacturing in non-farm employment from close to 40% in 1970 to less than 20% in 2015. This is shown in Figure 4, where the drop in the share of

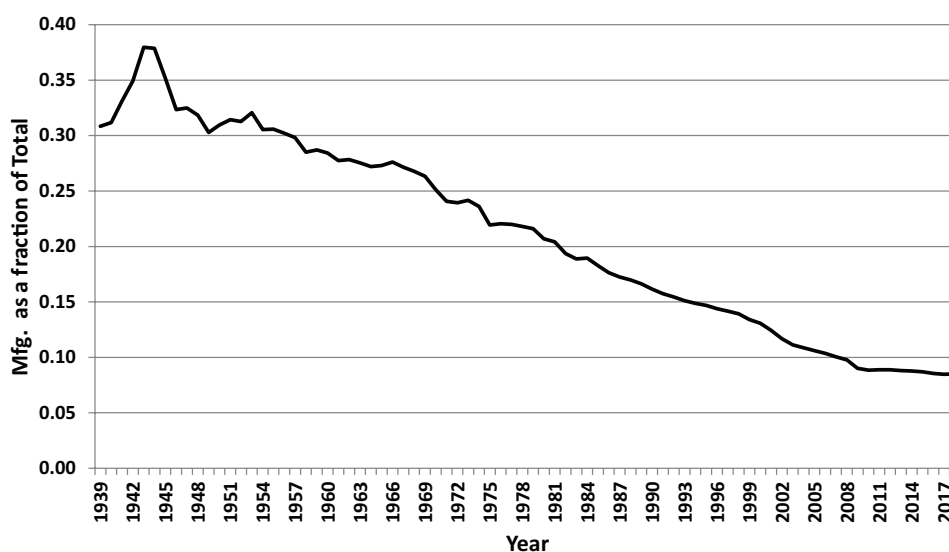


Figure 3. US manufacturing employment as a fraction of total US non-farm employment (1940–2018).

Source: Federal Reserve Bank of St. Louis, *Economic Data* (2019).

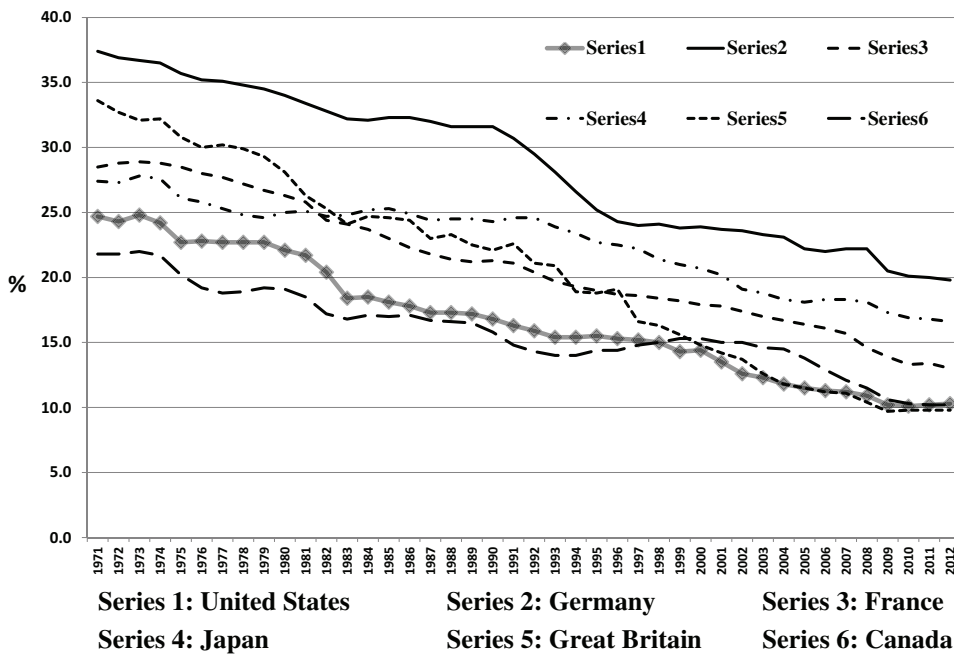


Figure 4. Manufacturing employment as a percent of total non-agricultural employment, industrial countries.

Source: Federal Reserve Bank of St. Louis, *Economic Data* (2019).

non-farm manufacturing employment in a set of high-income countries, from Great Britain to Japan, is depicted.

The vitriol against trade has been particularly directed at China, which is blamed for millions of American manufacturing jobs lost since the 1990s. A 2013 study by Autor, Dorn, and Hanson, for example, correlates Chinese imports with adverse impacts on manufactures in different parts of the US. Their study has been widely cited by journalists and by economists worried about competition with China, to the point of being described by some excitable economist columnists as the most important study in recent times. A second study by Acemoglu, Autor, Dorn, Hanson, and Price (2016) concludes that the surge of Chinese imports from 1991 to 2011 led to job losses in the US in the range of 2.0–2.4 million. It has also received substantial attention in the press.

But the claims in these studies are questionable. First of all, the authors assume that trade only involves imports, but in reality it involves both imports and exports. Just as US imports from China have increased so have American exports to that country. Those exports have created jobs in the US. To obtain an estimate of the impact of increased trade with China on US employment, one needs to consider the rising exports with China as well as the imports. Robert Feenstra and his

co-authors have carried out such an analysis and find that “the negative effects of import competition on US employment are largely balanced out once the country’s job-creating export expansion is taken into account” (Feenstra *et al.*, 2018). And these calculations do not consider the indirect employment effects of imports. In fact, in a world where parts and components come from everywhere, interference with imports imperils jobs everywhere. The success of parcel-delivery companies, for example, depends on imports, which must be brought from the borders inland, as well as on exports.

A second problem is that the decline of US manufacturing employment itself is partly connected to a statistical miscalculation. During the period involved, manufacturing production was reshaped, as many of its activities were unbundled and separated into various parts that could be undertaken anywhere in the world as part of global value chains (see Baldwin, 2017).³ Many of these activities — such as product design, R&D, distribution, and sales — which were considered in the past to be part of internal manufacturing production were reclassified as services. As the employees were cataloged as being part of the service sector (such as the wholesale and trade sector, for example), there was a statistically manufactured drop in manufacturing employment (see Bernard and Fort, 2013). Fort, Pierce, and Schott estimate the shifting employment shares and find that “non-manufacturing employment at manufacturing firms increases markedly between 1977 and 2012, enough to cause an increase in their overall employment.”

Of course, this reorganization of manufacturing production — which has been referred to recently as factory-less manufacturing — has meant that the strictly production-related activities of the firm have been heavily automated, resulting in a reduction of blue-collar operators and production workers (see Harrison and Montagne, 2017). The repercussions can be serious. Geographically, the manufacturing-related service sector jobs that have been generated by the factory-less manufacturing revolution have been in urban areas, while the shedding of production workers and operators has occurred in non-urban areas. Furthermore, as Fort *et al.*, find in a recent study, as much as a third of the increased employment in service-related activities undertaken by manufacturing firms are in high-skill professions such as design and engineering (Fort *et al.*, 2017).

These adjustments require social safety nets, retraining, and geographical mobility policies that allow workers — particularly semi-skilled workers — to adjust to the social and economic changes they suffer. But by no means would anti-trade policies help and instead they would impose greater pain on the displaced.

³Value chains is a misleading term since intermediates into a product go in many directions and bend back as well: France may import steel from Japan, but Japanese steel uses intermediates from around the world, including from France, and the problem afflicts each intermediate import.

The alarm raised by unsuspecting journalists about the findings of the Autor *et al.*, and the Acemoglu *et al.*, studies has clearly done much harm by helping to shape the recent protectionist zeitgeist.

There is yet another major problem with the position that US manufacturing decline since the 1990s is due to the growth of Chinese imports. This view is often postulated on the erroneous notion that the entry of China to the WTO eliminated the threat that country faced from possible US tariffs and led to the unabashed surge of exports to the US. But as Phil Levy of the Chicago Council of World Affairs has pointed out, if safeguard actions had been invoked against China — when China entered the WTO, added safeguards against China had been provided for — the effect would most surely have been to “shunt” exports from China on to other exporters. Of course, then the argument against competition with Chinese exports shifts to competition against total imports from China together with imports from these other suppliers, so import competition, as against competition only with Chinese exports, would then need to be reckoned with.

Indeed, the exclusive focus on China as the villain is misplaced. This can be understood by simply looking at America’s trade with its main partners. During the same period when imports from China rose, American imports from almost all of its trading partners have risen as well. This has resulted in growing all-around US trade deficits. Table 1 shows that the US has had ballooning trade deficits with China, Germany, Mexico, Ireland, Japan, and some of its other main trading partners.

And although the absolute trade deficit with China is apparently bigger than for other countries, this is a mirage. If you correct for size, China’s trade deficit

Table 1. Growth of US trade deficits relative to its main trade partners In billions of constant (2017) US dollars.

| Country | US trade balance | |
|-------------|------------------|------|
| | 1991 | 2017 |
| China | -23 | -375 |
| Germany | -9 | -65 |
| Mexico | 4 | -76 |
| Italy | -6 | -32 |
| France | 4 | -15 |
| South Korea | -4 | -23 |
| Ireland | 2 | -38 |
| Japan | -6 | -32 |

Source: Bureau of Economic Analysis, US Department of Commerce (2018).

Table 2. US trade deficits, selected countries, 2017.

| Country | US trade balance (billions of US\$) | Trade deficit with the US divided by country population (net exports per person) |
|-------------|--|--|
| China | -375 | \$270 |
| Canada | -23 | 638 |
| Germany | -64 | 771 |
| Mexico | -76 | 589 |
| South Korea | -23 | 447 |
| Japan | -70 | 552 |
| Italy | -32 | 528 |
| Ireland | -38 | 7,916 |

Source: Bureau of Economic Analysis, US Department of Commerce (2018).

with the US does not appear to be out of line with that of other countries. Table 2 divides the trade deficit by the population of each country. As can be seen, the per capita trade deficit of the US is the highest with Ireland, equal to a \$7,916 excess of imports relative to exports per person in that country, compared to \$270 for China, which in fact has the lowest trade deficit per capita of all the American trade partners in Table 2.

The point is that US imports have been growing big time with all of its trading partners, not just China. This suggests quite clearly that there is something else that has structurally increased US imports over time, something that has little to do with China. Most macroeconomists point to rising American spending on goods and services (corresponding to lower savings rates) as the main reason for the growth of US imports. As the US has increased its spending, including both private and public expenditures (through persistent budget deficits), so have imports from abroad. This is the real cause of the trade deficits. In fact, it is an unescapable macroeconomic identity that a trade deficit represents an excess of spending relative to income. And as Harvard's preeminent macroeconomist Martin Feldstein concludes, "Reducing the US trade deficit requires Americans to save more or invest less. On their own, policies that open other countries' markets to US products, or close US markets to foreign products, will not change the overall trade balance" (Feldstein, 2017).

Nothing More is to be Gained from Further Liberalization

This fallacy has been advanced by Dani Rodrik in writings such as the *Financial Times* and by others. But the fact is that there is still substantial room for trade liberalization.

Consider agriculture. The GATT negotiations that culminated with the Uruguay Round and the creation of the WTO in 1995 left in place a wide range of protectionist measures in this sector. The Agricultural Agreement was way weaker than the one applying to manufactured products. Poor countries have vociferously complained against the remaining protectionist measures in high-income countries, blaming the WTO for “unequal trade”, but they fail to mention their own agricultural protectionism.

Table 3 shows estimates of agricultural support by governments in rich countries, as calculated by the OECD’s Agricultural Policy and Monitoring Evaluation program (OECD, 2018). The total amount spent by high-income countries forming part of the OECD in 2017 was \$317 billion, which was equal to a whopping 26.8% of the value of total agricultural production in those countries. These are not small numbers. Tim Harcourt, the son of famed Australian post-Keynesian Geoff Harcourt and economist as well, has said that “[Y]ou could fly all the cows in France around the world, business class, for the same cost of the European Union’s agricultural subsidies”! (as quoted in Tokarick, 2008).

The protection is in the form of a wide array of instruments, including import tariffs, quotas, production and input subsidies, export subsidies, and direct payments to agricultural producers. The degree — and type — of protection varies among various countries. In the United States, for example, the protectionism has been mostly in the form of producer subsidies but in Japan and the EU tariffs and price-based protectionism is much more significant.

It is sometimes argued that the protectionism facing developing countries is overestimated because high-income countries provide special treatment to developing country imports through unilateral “trade preference” programs. This approach goes back to the Generalized System of Preferences (GSP), introduced in 1971 through a waiver and then granted legal status in 1979 with an enabling

Table 3. Expenditures on subsidies and other programs protecting the agricultural sector of high-income countries, 2017.

| | Billions of US\$ | Value of subsidies as a % of the value of agricultural production |
|----------------------------|------------------|---|
| OECD high-income countries | 317.0 | 26.8 |
| Japan | 51.3 | 65.5 |
| United States | 96.1 | 25.7 |
| European Union | 104.5 | 24.0 |
| Republic of Korea | 27.3 | 63.6 |

Source: OECD (2018).

clause at the GATT. Under this, the eligible poor countries are granted entry at preferentially lower tariff rates.

But the GSP programs are woefully inadequate. The eligible products often exclude those on which poor countries have pinned their hopes of increasing exports. Thus, the United States' GSP scheme excludes textiles, clothing, footwear, and steel products. Upper caps are also introduced. As of 2017, the United States imposes a limit (so-called “competitive need limit”) of \$90 million on its GSP imports per tariff line, per year, per country. Beyond this limit, the preferential rate vanishes. In addition, rules of origin requirements serve to curb exports from many eligible developing countries. Exported items have to satisfy stringent local-content specifications to qualify for GSP benefits.

Even the benefits granted are not “bound”, and could be varied at a rich country's displeasure. Among many other actions, the US suspended duty-free privileges under GSP for trade from Argentina between 2012 and 2017 and has recently revoked Ukraine's eligibility. Even the supposedly more generous United States' Africa Growth and Opportunity Act (AGOA), passed by Congress in 2000 — and currently extended until 2025 — which expanded the GSP program to include greater access for textiles and clothing, among other goods, has eligibility constraints that allow the President of the United States to determine country eligibility on an annual basis. The preferences can, therefore, be readily withdrawn for political reasons (and they have been) generating uncertainty that prevent investors and governments from participating in the program.

Developing countries have loudly complained about the agricultural protectionism in the rich countries. But they are guilty of the same crime. For instance, the weighted average tariff rate on agricultural imports in India is 33%, in Egypt it is 61%, in Thailand it is 31% and in Sudan it is 30%. A more detailed picture of the protectionist web that entangles agricultural trade in developing countries is presented in Table 4, where indicators of protectionist measures in Colombia, Indonesia, and Turkey are presented. For Indonesia, subsidies amounting to 29.1% of the value of agricultural production were in place in 2016. In Turkey, equivalent subsidies prevailed but in addition the average tariff on agricultural imports was

Table 4. Protectionism in the agricultural sector, selected countries, 2014–2016.

| | Colombia | Indonesia | Turkey |
|--|----------|-----------|--------|
| Tariff rate (%) Weighted average, 2014 | 12.0 | 4.2 | 42.2 |
| Tariff rate (%) Dairy products, 2014 (%) | 43.5 | 5.5 | 129.6 |
| Subsidies to the agricultural sector (millions of US\$) 2016 | 3,400 | 36,000 | 18,000 |
| Subsidies in 2016 as a % of the value of agricultural production | 13.7 | 29.1 | 29.2 |

Source: OECD (2018) and data from World Trade Organization (2018).

equal to 42.2%. Colombia had subsidies amounting to 13.7% of the value of agricultural production and an average tariff on agricultural imports of 12%, including a tariff of 43.5% on dairy products. These are just examples, as measures interfering with agricultural trade in the developing world are widespread.

The presence of agricultural trade protectionism in both rich and poor countries indicates that there is still much room for trade liberalization. This is especially the case since the end of the Doha round of multilateral WTO negotiations that started in Qatar's capital in 2001. These negotiations largely failed, resulting in the meek agreement signed at the 2015 Kenya Ministerial conference, which focuses mainly on trade facilitation instead of providing significant cuts on protectionist measures.

In addition to agriculture, there is still substantial room for trade liberalization in services and intellectual property; besides, even in manufactures there are many peaks which need to be ironed out.

Trade Leading to Growth is Wrong: The Causality is the Other Way Around

The evidence that trade liberalization is positively connected to economic growth is ample. However, some economists have argued that this does not indicate causality and that instead higher-income growth and/or greater investment rates may well be the cause of higher exports and trade instead of the other way around. Of course, this direction of causality is possible; and indeed countries that grow faster may well be able to liberalize more and, hence, may have higher growth of exports. But a number of in-depth studies of developing countries underline the robust nature of the exports-to-growth nexus, concluding that trade liberalization leads to — not follows — enhanced growth of income.⁴

Let us first consider the evidence showing an overall correlation between trade and growth. This does not seem to be that controversial, as many studies have corroborated it. For instance, Columbia University's Arvind Panagariya has shown in a well-known article in *The World Economy*, using data for several countries in the postwar period, that countries registering high-growth rates of exports have

⁴Dani Rodrik has argued that the main causal factor in the economic miracles of South Korea and Taiwan is rising investment rates (stimulated by government policies) and not increased trade (Rodrik, 1995). But a number of studies have found that trade liberalization has caused rising investment rates, not the other way around. For instance, Wacziarg and Horn find that investment rates in a wide range of countries rise significantly after episodes of trade liberalization, "confirming past findings that liberalization fosters growth in part through its effect on physical capital accumulation" (Wacziarg and Horn, 2008, p. 187).

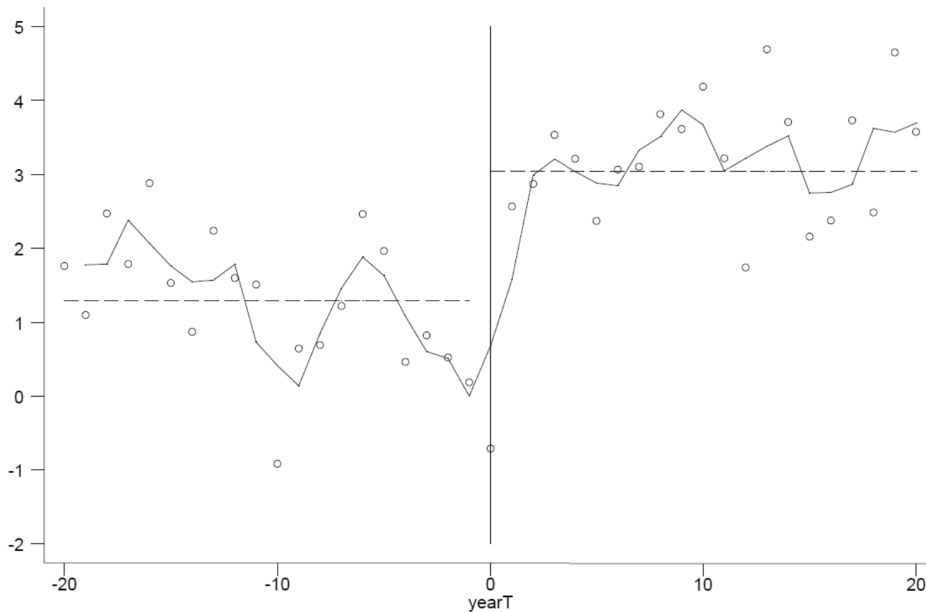
also grown more rapidly. Sebastian Edwards at UCLA has found similar results for a sample of developing countries (Edwards, 1993).

Another well-known study is that of Dollar and Kraay (2002). These authors catalog developing countries into two groups: globalizers and non-globalizers. Globalizers are developing countries that have had an increase in the trade (exports plus imports) to GDP ratio after 1980, while non-globalizers are developing countries that have displayed a drop in that ratio. The globalizers had also much lower barriers to trade than the non-globalizers. They then examine the economic growth experience between 1980 and 1999 of the globalizers and non-globalizers. The globalizers have had rising growth rates, from 1.8% per year in the 1970s to 2.5% in the 1980s and 5.1% in the 1990s. By contrast, the growth rates of the non-globalizers actually declined from 2.6% per year in the 1970s to -0.1% in the 1980s and -1.1% in the 1990s.

The research of Jeffrey Frankel and David Romer focuses more specifically on the endogeneity problem involved in measuring the causal effects of trade on income. Higher income increases trade, so how to make sure, statistically, that trade causes greater income growth and not the other way around? Econometricians use instrumental variables in order to distil the causal impact of one variable on another. Frankel and Romer use geographical distance as an instrumental variable, since trade rises with geographical closeness but a country's geographic characteristics are not affected by its income or by policies and other factors that affect income. In contrast to earlier studies, they find substantial causal effects of trade on income, with an increase of 1 percentage point in the ratio of trade (the sum of the absolute value of exports and imports) to GDP raising income per capita of a country by at least one-half percent (Frankel and Romer, 1999, p. 394). But global trade increased from 36% to 61%, or 25 percentage points, between 1986 and 2011. Following Frankel and Romer's result, this increment of trade would have caused an average increase in income per capita of 1.4% per year during this 25-year period. This is impressive, given that the average annual global growth rate of GDP per capita between 1986 and 2011 was 1.9%!

Evidence of the positive impact of trade on growth is also available from case studies of liberalizing countries. For example, the Indian experience shows that, once India embarked in 1991 on reforms which included reducing trade barriers, the growth rate accelerated and this, in turn, finally reduced poverty, showing that growth was a "pull-up", not a "trickle-down" strategy. It was the change in policies introduced with economic reforms in 1991 onwards that improved trade performance and hence led to enhanced growth rate of GNP.

Similarly, Wacziarg and Horn (2008) establish causal effects by examining whether trade liberalization events in a country cause an increase of economic growth in the time period after the liberalization when compared to the situation



- represents the sample mean for the annual rate of economic growth
- represents the sample mean for the rate of growth before and after trade liberalization
- represents a 3-year moving average for the rate of growth

Figure 5. The effects of trade liberalization on economic growth.

Note: Year T: year of trade liberalization. Vertical axis is annual percentage.

Source: Wacziarg and Horn (2008).

before. The results are presented in Figure 5. The vertical axis shows the average rate of growth of per capita income in the sample of countries in their dataset before and after the time when trade liberalization occurred, referred-to in the diagram as time *T*. As can be seen, economic growth after trade liberalization is on average substantially higher than that prevailing before the liberalization, perhaps as much as 2 percentage points higher on average.

Now, we are not arguing that trade liberalization is the only policy change that promotes growth. In fact, there are a number of policies that are complementary with and strengthen the impact of trade. Exports require finance and therefore policies that stimulate higher investment rates and a more diverse and stronger financial system are essential for trade liberalization to become an engine of growth. Infrastructure — roads, ports, etc. — is essential to ship the products that are the backbone of trade; so government policies that promote the development and maintenance of such facilities are also key for trade to thrive. And of course, rent-seeking corruption is a cancer that can prevent trade from taking-off and/or

cause most of the benefits from that trade to be diverted into a few in power.⁵ But it cannot be ignored either that in many countries liberalizing trade has been a leading force in promoting good governance and that protectionism on the other hand has caused destructive corruption and poor governance.

Concluding Remarks

The world trading system is at a crossroads. The protectionist myths discussed in this chapter have spread like a virus among politicians, in the public and even among some academics. In a world of fake news, only a serious analysis and dissemination of the facts can contradict the anti-traders.

There are legitimate claims among those who have been left out of the global economic expansion in recent decades. That is not in question. But the appropriate reactions and the right policies need to be targeted. Protectionism is not one of them. In America, the reviled trade deficits can only be solved by stimulating savings and reducing the continuous budget deficits and spiraling external public debt that go back to the early 2000s. And the current and future labor market challenges created by robotics and artificial intelligence will not be solved by restricting trade but by investments in education and in high-level cognitive and non-cognitive skills, on the one hand, and in implementing policies that provide safety nets and facilitate the adjustment of the displaced on the other. The fallacy that protectionism is the answer in combating poverty, inequality, and socioeconomic marginalization is toxic and must be actively countered.

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⁵This is the case of many countries involved in the extraction and export of natural resources. The expansion of rent-seeking and corruption partly explain why natural-resource rich do not grow faster than other countries, holding other things constant. But cutting-off trade is not the answer for these problems, of course. The natural resource curse can be exorcised through the appropriate policies and good governance, as the cases of Norway, Botswana and Chile attest to (see Frankel, 2012).

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