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A Radical Plan to Manage Globalization

Calling free trade "as outdated as the dodo," Economist Vladimir Masch offers solutions to what he sees as big problems for the U.S.

by Vladimir Masch

The U.S. is currently in a precarious position. In addition to geopolitical threats, we face a severe economic shock. We have already lost trillions of dollars and millions of jobs to foreigners. Our potential adversary is our largest creditor, and our country has lost every important large-scale economic weapon that can be used in thorny geopolitical situations. As argued by Princeton economist Alan Blinder, we are at the beginning of a third industrial revolution. Blinder says that of about 140 million U.S. jobs, between 42 million and 56 million could be moved offshore in the next decade or two: all 14 million current jobs in manufacturing and 28 million to 42 million in the service sector. We will be left without any manufacturing, which is an inalienable part of the country's security. Education and skills may not help. U.S. wages will go down sharply.

All these devastating changes come from a blind following of an "orthodox" dogmatic free-trade policy, currently used by the U.S. It brings great benefits to many, but it is very dangerous for American society and the world. Any absolute dogma is a bad bedfellow for the economy. The Soviet Union on the left and free trade on the right are good examples. No society can prosper with extremism.

TROUBLES AHEAD

Can we constrain extremism and direct the economy to activities that are beneficial to society? Regardless of the objections of laissez-faire free-trade economists, the U.S. must seek low unemployment, a sufficient growth rate, stable prices, a healthy balance of payments, the preservation of the industrial base, the attainment of geopolitical goals, and the preservation of the middle class. Without a strong middle class, a country is polarized, and democracy cannot survive in a polarized society. If nothing is done, the U.S. may turn sharply left and go the way of Venezuela. The current shift to the left in Latin America may have come from globalization.

Free-traders deride any intervention in trade matters as "central planning." The international General Agreement on Tariffs & Trade falls in that sinister-sounding category of "central planning": its Article XII declares that any country "in order to safeguard its external financial position and its balance of payments, may restrict the quantity or value of merchandise permitted to be imported." The Balanced Trade Restoration Act, introduced last year by Senators Byron Dorgan and Russ Feingold, falls into the same category. Most important, so does the just-announced Horizon Project, which is intended to be a Marshall-type Plan for America and has been authored by 11 eminent chief executives and policy innovators. For that matter, doesn't the Federal Reserve exercise "central planning"? Mea culpa—this article is in the same category.

The free-trade economists fail to understand or refuse to admit that their approach to organizing international trade can be successful only under rare combinations of the favorable conditions that prevailed before World

War I and shortly after World War II. Conditions in this century are bad and will get much worse, and free trade is now as outdated as the dodo.

NEW INDUSTRIAL REVOLUTION

Why isn't free trade theoretically justified today? Which conditions became outdated? In the real world there exist a multitude of conditions that are incompatible with utopian assumptions of the presumed theoretical rationale of free trade, the "law of comparative advantage." Each of these conditions is important; their cumulative effect is overwhelming and devastating. As a consequence, in the real world the "law" is invalid, inapplicable, and irrelevant.

For example, one of its major faults is that the "law" takes into account only the benefits that a country receives by specializing, not the negative externalities, or adjustment costs. In the real world, these costs might easily bury the advantages.

As far as free trade is concerned, economics is not a science. True, it is a consistent theory, but it is relevant only in some utopian world, rather than under real-life conditions. This fact is carefully concealed from the public.

But even if all utopian conditions are met, and even under full employment, it has been rigorously proved (by three independent teams of preeminent economists, founders of the contemporary international trade theory) that wages in all free-trading countries would be equalized at a sufficiently low level. Under persistent unemployment, and under the conditions of the new industrial revolution, it will be much worse: In every category of labor, excessive supply will overwhelm any possible growth of demand. (The average American wage is about $135 per day. The average Chinese wage is around $135 per month, for 14 to 16 hours of work a day, seven days a week, under very harsh sweatshop conditions; some factories pay $50 to $80 per month. For political stability, China needs 15 million to 20 million new jobs per year, with about 700 million standing in wait just in China, and about 2,300 million in other countries. Again, the U.S. has only about 140 million jobs, about 50 million of them transferable.)

UNSUSTAINABLE

Economists keep mum about all these results, which would make free trade unacceptable to Americans. An enormous, relentless, and shameless propaganda machine brainwashes the country into believing that free trade and uncontrolled globalization are theoretically sound, remain the only rational or even unavoidable options, and are good for the U.S. This is wrong. Free trade and globalization are not good even for Big Business; they are good only for its top executives and investors.

The judgment about the desirable, acceptable, and affordable forms of trade and globalization has to be made by American society, considering the totality of economic and noneconomic factors. It should be made after learning the truth about the falsity of free-traders' claims and about the cost of globalization in jobs and money.

What can be done to improve the situation? Slow and indirect approaches, such as attempts to increase the U.S. savings rate, will be insufficient: In a few years, just the annual returns on foreign holdings of U.S. securities will reach half a trillion dollars. The currency reserves of China alone, predominantly held in U.S. debt securities, now exceed $1 trillion and are expected to double in four years. This is an ever-growing mortgage on our country. Even President George W. Bush, a devotee of free trade, considers this situation unsustainable. We have to take the bull by the horns, and we have to do it immediately.

COMPENSATED FREE TRADE

Free trade has to be saved; the U.S. cannot and should not completely back out of it. But the rules of trade must be modified: It is sufficient merely to remove some bad side effects of trade, such as excessive deficits. For that purpose, I propose a policy of "compensated free trade." Here's how that policy would work:

• Congress sets annual limits (upper bounds) on the overall U.S. trade deficit in consumer goods and undesirable capital goods (oil and gas excluded).

• The President of the U.S. allocates the allowed deficit for each of our trading counterparts—countries or groups of countries.

• A country may exceed the limit if its government pays the U.S. Treasury a stipulated percentage (up to the full amount) of the excess deficit, also approved for each country by the President of the U.S. These payments may be capped.

• To raise the money for excess deficit payments, our trading counterparts may either use export taxes and export certificate auctions or pay from their currency reserves.

The proposed policy promises to become a powerful and versatile economic tool. Among many other accomplishments, it would control globalization, save American jobs, prevent trade wars, stop predatory trading, and impose financial discipline on our Micawberish country.

CHINESE CENTURY

Moreover, it also will be a geopolitical tool, a weapon of diplomatic persuasion. It will allow us to reward our friends and penalize our enemies. But, above all and best of all, it will be perhaps the least confrontational means of geopolitical containment of potential rivals and adversaries, such as China. We need such a capability badly, much more than we did 60 years ago, because we are simultaneously attacked on many geopolitical and economic fronts. (Both the Dorgan/Feingold bill and the Horizon Project also recommend capping the trade deficits. Time has come for that action. But compensated free trade is probably more flexible and suitable to be used as a tool of geopolitical containment and diplomacy. We hope that the additional beneficial features of our policy will be included in the revised versions of these excellent proposals.)

Both free trade and globalization have to be controlled. If we do not replace both of them with a better policy, the U.S. could either become strongly protectionist or a number of dire consequences will follow: We will lose our middle class and a substantial part of our wealth and our economy, the U.S. will become polarized and may turn sharply left (perhaps together with some other countries), and the 21st century will be a Chinese century.

The proposed compensated free trade is a good candidate to be such a better policy. True, it involves a radical change, which is always risky. We might have to implement that policy slowly and carefully, all the time thoroughly analyzing both the newly emerging and the potential long-term consequences. The inherent flexibility of the policy, however, makes it a superb risk-management tool.

"MACROECONOMIC AGONY?"

Philip Levy, of the American Enterprise Institute, offers a rebuttal to the compensated-free-trade proposal in a companion piece (see BusinessWeek.com, 2/14/07, "Trade Truths for Turbulent Times"). But the rebuttal has no solid counterarguments. Even more important, the rebuttal (and free trade, in general) has no alternative proposals. It does not repudiate the serious charge that the trade theory does not take adjustment costs into account and compares benefits only.

Statements about "winners sharing with losers" are just empty talk: There will be almost no winners in this country. Also, note a delicate nuance: "The winners could compensate losers if they chose to." Would you trust the winners? Moreover, by the 1940s it was already proved that even theoretical work in that direction leads to difficulties that are insurmountable in principle.

Two rejoinders are presented in the rebuttal's last paragraph; both are wrong. First, if a country enters a trade war against us, it would shoot itself in the foot. Second, the rejoinder about "macroeconomic agony" would apply only to a small country, not to the U.S. with its enormous internal market, where the connections between foreign trade and growth are incomparably weaker.

As to the disaster to come from compensated free trade, predicted in the same paragraph, it looks like an enormous improvement in comparison with the national catastrophe that awaits us if we "stay the course" of unbridled free trade. Besides, as discussed, our proposal would be phased in gradually and cautiously to avoid any disasters.

Author's Note: This article presents results obtained in joint work with the late Mark Perlman, the University Professor of Economics (Emeritus) at the University of Pittsburgh. Copyright 2005–2007, Dr. Vladimir A. Masch

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