

New and improved trade agreements?

By Jeffrey Frankel

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Trade is high on the agenda in the United States, Europe, and much of Asia this year. In the US, where concern has been heightened by weak recent trade numbers, President Barack Obama is pushing for Congress to give him Trade Promotion Authority (TPA), previously known as fast-track authority, to conclude the mega-regional Trans-Pacific Partnership (TPP) with 11 Asian and Latin American countries. Without TPA, trading partners refrain from offering their best concessions, correctly fearing that Congress would seek to take “another bite of the apple” when asked to ratify any deal.

In marketing the TPP, Obama tends to emphasize some of the features that distinguish it from earlier pacts such as the North American Free Trade Agreement (NAFTA). These include commitments by Pacific countries on the environment and the expansion of enforceable labor rights, as well as the geopolitical argument for America’s much-discussed strategic “rebalancing” toward Asia.

As with consumer products, the slogan “New and improved!” sells. NAFTA and other previous trade agreements are unpopular. So the Obama administration’s argument is apparently, “We have learned from our mistakes. This agreement will fix them.”

But the premise is wrong: The previous agreements did benefit the US (and its partners). The most straightforward argument for TPP is that similar economic benefits are likely to follow.

The economic arguments for the gains from trade of course go back to David Ricardo’s classic theory of comparative advantage. Countries benefit most from producing and exporting what they are relatively best at producing and exporting, and from importing

what other countries are relatively better at producing.

Moreover, trade boosts productivity, which is why exporters pay higher wages than other companies, on average – an estimated 18% higher in the case of US manufacturing. And the purchasing power of income is enhanced by households’ opportunity to consume lower-priced imported goods. The cost savings are especially large for food and clothing, purchases that account for a higher proportion of lower-income and middle-class households’ spending.

American trade debates have long been framed by the question of whether a policy will increase or reduce the number of jobs. This concern is a first cousin to the old mercantilist focus on whether a policy will improve or worsen the trade balance. A “mercantilist” could be defined as someone who believes that gains go only to the country that enjoys a higher trade surplus, mirrored by losses for the trading partner that runs a correspondingly higher deficit.

Even by this sort of reasoning, one could make an “American” case for the ongoing trade negotiations. The US market is already rather open; TPP participants such as Vietnam, Malaysia, and Japan have higher tariff and non-tariff barriers against some products that the US would like to be able to sell them than the US does against their goods. Liberalization would thus benefit US exports to Asia more than Asian exports to the US.

The late 1990s offer a good illustration of how trade theory works in the real world. The volume of trade increased rapidly, owing partly to NAFTA in 1994 and the establishment in 1995 of the World Trade Organization as the

successor to the General Agreement on Tariffs and Trade.

For the US during this period, imports grew more rapidly than exports. But the widening of the trade deficit had no negative effect on output and employment. Real (inflation-adjusted) GDP growth averaged 4.3% during 1996-2000, productivity increased by 2.5% per year, and workers received their share of those gains as real compensation per hour rose at a 2.2% annual pace. The unemployment rate fell below 4% – as low as it goes – by the end of 2000.

A stronger trade balance in the late 1990s would not have added to output growth or job creation, which were running at full throttle. Further increases in net export demand would have been met only by attracting workers away from the production of something else. That is why the gains from trade took the form of bidding up real wages, rather than further increasing the number of jobs.

Admittedly, it is harder to make the case for freer trade – particularly for unilateral liberalization – when unemployment is high and output is below potential, as was true in the aftermath of the financial crisis and recession of 2007-2009. Under such circumstances, there is a kernel of truth to mercantilist logic: trade surpluses contribute to GDP and employment, coming at the expense of deficit countries.

Of course, if one country erects import barriers, its trading partners are likely to retaliate with “beggar-thy-neighbor” policies of their own,

leaving everyone worse off. That is why the case for multilateral renunciation of protectionism is as strong in recessionary conditions as ever. In response to the 2008-2009 global recession, for example, G-20 leaders agreed to refrain from new trade barriers. Contrary to many cynical predictions, Obama and his counterparts successfully fulfilled this commitment, avoiding a repeat of the debacle caused in the 1930s by America’s introduction of import tariffs.

In any case, mercantilist logic is no longer relevant. The US unemployment rate has fallen well below 6% – not quite full employment, but close. If output and employment were rising this year as rapidly as in 2014, the Federal Reserve would probably have felt the need to start raising interest rates as early as this June. As it is, the Fed will almost certainly delay raising rates for a while longer. If trade deals do boost US exports more than imports, the Fed will probably have to put a brake on the economy that much sooner.

But the bottom line is that if the US can boost auto exports to Malaysia, agricultural exports to Japan, and service exports to Vietnam, real wages will be bid upward more than by the creation of more jobs. That is why, if it is allowed to proceed, the TPP will, like past trade deals, help put real median US incomes back on a rising trend.

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