Free trade's diminishing returns

By Jomo Kwame Sundaram and Vladimir Popov
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In its May 2010 "Global Survey," McKinsey & Company reported that, "the core drivers of globalization are alive and well." In an April 2014 report, the firm went further, declaring that, "to be unconnected is to fall behind."

But now McKinsey seems to have changed its tune. In a new report, "Poorer Than Their Parents? Flat or Falling Incomes in Advanced Economies," the McKinsey Global Institute asserts that developed countries should not expect further gains from the process of globalization. Income growth has stalled since the 2008 financial crisis and "even a return to strong GDP growth may not" reverse the trend.

Specifically, McKinsey finds that, from 2005 to 2014, real (inflation-adjusted) incomes remained flat or fell in 65-70% of households comprising 540 million people across 25 advanced economies. In the United States during this period, 81% of the population experienced flat or falling real incomes; in Italy, 97% did. By comparison, from 1993 to 2005, advanced-economy real incomes remained flat or fell in less than 2% of households.

Government transfers and tax cuts mitigated some of this trend's effects by leaving families with additional take-home income, especially in strong welfare states. But even with those measures, up to a quarter of households in some countries experienced stagnant or lower disposable incomes between 2005 and 2014.

The years since 2005 have shown globalization to be a double-edged sword, and even conservative politicians worldwide have stopped cheerleading for it. As former French Prime Minister Dominique De Villepin recently put it, "Globalization, on the one hand, promotes cooperation; on the other hand, [it has] brought new mutual exclusion, isolation, and radicalization."

In the US, Donald Trump won the Republican Party presidential nomination on an anti-trade, anti-immigration platform. Trump's base of support comprises white working-class voters who feel that globalization has destroyed their prospects for economic success and security. Trump has explicitly appealed to these voters' prejudices and has called for "Americanism, not globalism."

The "Leave" side in the United Kingdom's Brexit referendum orchestrated a similar campaign, and xenophobia and ethno-populism are resurgent throughout the West. Some of the blame for this goes to Western governments that, ignoring the uneven effects of free trade, failed to assist the "losers."

To be sure, free trade can reduce prices for consumers and raise real incomes for some workers. But it often does so at the expense of other workers who are displaced when companies, competing on a cutthroat international stage, move jobs elsewhere. Over time, while many people in a few countries have benefited, many others have lost more in real income than they've gained from low-cost imports.

Only a few governments managed this difficult tradeoff well, by providing adequate unemployment compensation and skills training, and promoting new, more remunerative employment opportunities. And at any rate, such measures address only the dislocations from trade within countries. They do not account for larger international forces at work, especially those affecting developing countries that cannot afford strong social-welfare programs.

One option for mitigating globalization's international displacement effects is "aid for trade," which the Columbia University economist and free-trade evangelist Jagdish Bhagwati proposed over a decade ago. Bhagwati recognized that free trade can be a disruptive force that requires international coping mechanisms, especially for less dynamic developing countries. He called for financial transfers from advanced to developing economies to compensate for displaced productive and export capacities (and lost tax revenues), and to enable recipient countries to overhaul those capacities to become more competitive.

Navigating the economic transition to international competitiveness isn't easy. It often requires government interventions to coordinate resources, build infrastructure, and manage export-promotion projects. Moreover, policymakers must view comparative advantage dynamically, rather than in terms of traditional comparative static ("before and after") analytics. International competitiveness is not just about low costs, but also about quality control and customer satisfaction, none of which magically happens overnight. Thus, in many cases, measures that cushion the transition are essential.

Unfortunately, the new generation of investment and free-trade agreements that American and European leaders are pushing for today – often with exaggerated promises of economic benefits – provide for none of this. With global trade already significantly freed up – and with incomes already stagnant or falling – claims that new FTAs will boost incomes are dubious, at best.

On the contrary, for developing countries, proposed agreements like the Trans-Pacific Partnership pose serious threats: their non-trade provisions strengthen the hand of financial rent-seekers, intellectual-property owners, and multinational corporations vis-à-vis governments – all of which would hold emerging economies down, rather than helping them up.

We've heard from globalization's victims in developed countries, where most people have seen no income gains in more than a decade. But if these non-trade provisions are adopted, we will soon see a backlash in developing countries as well, unleashing political and economic consequences the likes of which we can hardly anticipate.

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