The case for compensated free trade

By Robert Skidelsky
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According to Harvard's Dani Rodrik, the nation-state, democracy, and globalization are mutually irreconcilable: we can have any two, but not all three simultaneously. In fact, there may be a solution to Rodrik's "trilemma."

Almost all liberals support globalization and oppose economic nationalism. They ignore the mounting evidence that, in its current form, globalization is dangerously incompatible with democracy.

In his 2011 book *The Globalization Paradox*, Harvard's Dani Rodrik says that the nation-state, democracy, and globalization are mutually irreconcilable: we can have any two, but not all three simultaneously (he calls this a "trilemma"). All over the world, the "nation" has been revolting against globalization in the name of democracy.

That became clear this year when US President Donald Trump imposed the first of a widening set of tariffs against Chinese goods, with China retaliating in kind. Trump has also torn up two major international trade treaties and threatened to withdraw from the World Trade Organization.

The trigger for America's turn to economic nationalism is its widening trade deficit – $566 billion in 2017, and growing – as the US economy recovers. But the deeper reason is the correct perception that the resulting current-account deficits are not "benign" when they are being financed by inflows of short-term capital, or "hot" money.

A current-account deficit means that a country is importing more than it is exporting. And those excess imports can lead to a net loss of "good" jobs. Six million manufacturing jobs disappeared in the first decades of the 2000s. The Rust Belt made Trump president. "It's time to rebuild Michigan, and we are not letting them take your jobs out of Michigan any more," he told cheering crowds in Detroit in 2016.

Trump's protectionism also has a geopolitical root. Metal imports have led to the closing of many enterprises that might be needed for defense. China's strategic "Made in China 2025" plan is a high-tech industrial policy aimed at transforming China into a dominant global leader in the industries of the future. It significantly relies on stealing advanced technologies from the United States. If MIC25 is successful, the US will have a depleted economic and political future.

In strictly economic terms, the political character of one's trading partners should not matter. However, in a world of strategic competition, international commerce can be, and usually is, an instrument of policy, and its use in that context should not be denied simply because it breaches the sacred principle of free trade. As Friedrich List, the nineteenth-century pioneer of economic nationalism, pointed out, free trade assumes a peaceful world.

Selective tariffs can be useful for protecting defense-related industries or to prevent other countries from stealing cutting-edge technologies. But as an overall trade policy, tariffs are crude and inexact. The US will incur high costs and might end up without a substantially lower trade deficit or other meaningful benefits.

Is there a way to limit free trade that does not lead to trade wars? The economist Vladimir Masch has advocated an ingenious "compensated free trade" (CFT) plan as a way to achieve legitimate protectionist aims without disrupting the world economic system.

Under this plan, policymakers would establish a ceiling for the trade deficit each year and impose limits on trading partners' surpluses. (Any products needed from a surplus partner would be exempted from the partner's export limit.) In the US case, this ceiling would largely affect China, Mexico, Japan, and Germany, which contributed $375 billion, $71 billion, $69 billion, and $64 billion, respectively, to the overall trade deficit in 2017.

Under CFT, a trade surplus country can reduce its exports to the set limit. But it could also exceed its export quota if its government paid the partner government a fine equal to the value of the excess exports, either collecting the necessary sum from its export producers or using its currency reserves. (The receiving government could use the fines to enlarge its own investment programs.) But if the surplus country tried to exceed its export limit without paying the fine, its surplus exports would be blocked.

This "smart" protectionism has several advantages over crude tariffs. First and foremost, it would automatically prevent trade wars. Because CFT imposes limits just on the trader's surplus, any attempt by the surplus country to decrease the value of its imports from the US would automatically decrease the value of its allowed exports.

Second, CFT would confront, in one stroke for each partner, government subsidies, price and currency manipulations, and the other dirty tricks of international trade. In contrast to prolonged and often fruitless haggling over trade treaties, results would be obtained immediately.

Third, by re-balancing the financial and trading arrangements of the global economy's participants, CFT would represent a step toward addressing its current dysfunction. CFT is not a complete solution, because it leaves open the question of who should adjust to whom. A reformed global payments system, which mandates symmetrical adjustment of global imbalances, would need to tackle this issue.

Fourth, because of America's leverage, its adoption of CFT would "nudge" reluctant trade surplus countries to accept such a payments system. Global finance would have to operate within the limits that a balanced payments system establishes.

Fifth, in terms of economic benefits to the US, implementing CFT would stimulate the return of off-shored enterprises and jobs, thus restoring the country's industrial potential and social balance.

From a historical perspective, CFT essentially amounts to a unilateral activation of the scarce-currency clause (Article 7) of the Bretton Woods Agreement, which allowed the International Monetary Fund to declare "scarce" the currency of a country running a persistent trade surplus, permitting other members to discriminate against its goods. It is consistent with Article XII of the General Agreement on Tariffs and Trade (the WTO's predecessor), which states 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."

In short, CFT addresses trade deficits, overcomes the limitations of tariffs, fights trade manipulation, corrects current mainstream economic theory, and is a necessary step toward re-establishing a feasible global payments system. In a nutshell, it overcomes the Rodrik trilemma: one can have the nation-state, democracy, and globalization at the same time.

But only one nation-state, the US, has the clout to deliver this. By doing so, it would stop the global stampede to a virulent form of economic nationalism. For that reason alone, the Masch plan deserves serious consideration.

Robert Skidelsky, Professor Emeritus of Political Economy at Warwick University and a fellow of the British Academy in history and economics, is a member of the British House of Lords.